HYPO ALPE ADRIA
S VAMA. UZ VAS. ZA VAS.

Annual Report 2011

Hypo Alpe-Adria-Bank a.d. Banja Luka

Bosnia and Herzegovina

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Mission and principles

Headquartered in Banja Luka, Hypo Alpe-Adria-Bank a.d. Banja Luka is the largest bank in the Republic of Srpska and we consider ourselves the most valuable brand in the domestic financial industry.

Working in partnership with citizens, local communities, small and medium enterprises, businesses and public institutions, we provide a wide range of financial services and products that are simple, creative and modern, with the primary objective to bring the best result for more than 200 thousand of our clients in over 40 municipalities in RS.

- Success for all: for our customers, shareholders and employees
- Responsible banking: ethical and transparent business and consistent application of laws and international standards

Letter from the Management Board

Dear shareholders and clients,

In 2012 Hypo Alpe-Adria-Bank a.d. Banja Luka celebrates a very important jubilee – the 10th anniversary of its presence in the Republic of Srpska market. Our special anniversary gives us an opportunity to look back at our history and prepare for the future.

It is also an opportunity to show, with dignity, who we are and what we have accomplished in the domestic market as well as to look forward to everything that we will be able to accomplish in the years to come.

The heritage enjoyed by our Bank is something that not a lot of banks can boast about. Following the acquisition of Kristal Bank in 2002, Hypo Alpe-Adria-Bank International AG took over a respectable financial institution that was running business since 1971, as the main branch of then banking giant Jugobank.

Since 2002 to date our main mission has been to employ our capital in the service of the domestic market and the development of domestic economy. Throughout the decade we have been led by our desire for the result---trying to help our clients to progress from the ambition toward reaching the goal --- which is a task especially difficult nowadays as our clients are faced with the uncertainties brought by the future.

Since 2002, when Hypo Bank entered the domestic market, up until now this bank has granted over 2,6 billion BAM of retail and corporate loans and in ten years has become the biggest in RS, as well as one of the most successful banks on the level of Bosnia and Herzegovina. During that period, Hypo Bank paid 122 million BAM of interest on savings and deposits to citizens, economy and the Republic of Srpska public sector, which is an additional evidence showing its commitment and strategic importance for the RS economy. Moreover, beside the business successes, Hypo Bank has been a pioneer in promoting the Corporate Social Responsibility by donating more than half a million BAM of funds to institutions and associations in charge of the education and development of children and their health and social welfare.

Hypo Bank Banja Luka is at the moment a very liquid financial institution with the strongest capital base, capable of providing services of equal quality to the citizens in their efforts to ensure a better living for themselves, to the economy, in its attempts at making new business successes, and to the public sector as an incentive for starting big infrastructure projects throughout the Republic of Srpska.

Global economy may change rapidly and in many ways, but our role remains the one of a financial bedrock that connects our clients with success and success with our clients.

Financial performance in 2011 ---Historical result

Our Bank is in top shape and exceptionally well positioned for the future. For the first time since our presence in the domestic market, we made this high net profit of 23.2 million BAM (26.8 million BAM before taxes). At the same time, this is a historical result in the Republic of Srpska finance industry, which makes our success even more worthwhile.

Hypo Bank Banja Luka is a leader in all five key banking categories: assets, deposits, loans, profit and capital.

The Bank's assets amounted to 1.4 billion BAM, while the total deposits amounted to over 1 billion BAM, recording a significant growth trend. In the last year Hypo Bank extended over 230 million BAM of new loans in the Republic of Srpska market, which is by almost 50 percent more compared to 2010 – the bank thus confirmed its commitment for investing in the Republic of Srpska economy even in the time of global crisis.

Our total capital amounted to 234 million BAM and is the best proof of our strength and the stability of our Bank as well as the commitment of our owner, Republic of Austria, for developing a long-term stable and respectable financial institution in the Republic of Srpska.

Total loans of the Bank were at the level of 1.1 billion BAM. The last year was also marked by our founding of a leasing company, Hypo Alpe-Adria-Leasing d.o.o. Banja Luka, the goal of which was to increase the product base and offer the best possible service to our clients. The growth of card operations and e-services, SMS and e-banking, has also continued, resulting in an increase in non-interest bearing income.

All these results were not only a consequence of mere chance, but a product of a clear vision and an energetic and fast restructuring process that lasted for more than a year. That process aimed at making the system more efficient and functional on the whole. We have done a lot on restructuring the loan portfolio, on resolving the issue of non-performing loans, cutting expenses, increasing non-interest bearing income, improvement of business processes and in the same time conducting the conservative application of international accounting standards both in the domain of credit and operational risk.

We have kept a focus on business with citizens, small and medium-sized enterprises and entrepreneurs as well as with public institutions. In our lending activities, we have proved to be much more active compared to 2010, however we still kept to the principle of strict treatment of risks with new loans and looking for clients with credit worthiness and quality security instruments. An extensive growth of citizens' savings and domestic legal entities' deposits as the primary local source of financing continued, thus showing great trust that Hypo Bank Banja Luka enjoys in the local market. High and stable interest income has been accomplished.

Subordinating our capital to the needs of the domestic market and the development of the local economy at the time of the global crisis was something that was also recognized by the Republic of Srpska Chamber of Commerce from which we received an award for the highest amount of loans granted to the local economy. We are especially glad at the fact that all these successes came at the right time, when our bank celebrates a jubilee, the tenth anniversary of its presence in the Republic of Srpska market.

Strong, stable and responsible banking

As a member of Hypo Alpe Adria, which is 100% owned by the Republic of Austria, a country member of the European Union, Hypo Bank Banja Luka consistently applies local regulations, regulatory rules of the Republic of Srpska Banking Agency, as well as international accounting standards and the International Financial Reporting Standards, with special emphasis on credit risk treatment. We make maximum use of the knowledge and experience of our owner Hypo Alpe Adria in our daily work, and we try to use that know-how as our advantage in the domestic market. We can take full responsibility in saying that the bank's credit portfolio is secured in the best possible way, providing security to the bank itself, its shareholders, clients and the market in which it operates. The bank is maximally liquid and strong in terms of capital, which gives us enough of strength and stability to meet the needs of our market. The Supervisory Board and Management Board of the Bank are paying a great deal of attention to the internal audit and internal control system, putting thus additional effort in immediately detecting any possible deficiencies and irregularities in the work and solving them in a good manner with minimum consequences. Each control of local regulators and the external auditor is taken very seriously and execution of their orders is closely monitered. Additional energy and logistics are invested in the field of operational risk.

Looking into the future

How can a company accomplish an important innovation without additional capital increase?! How can any investor run a safe business and expect a future success without risk management?!

That is where we, Hypo Alpe Adria Bank a.d. Banja Luka, come in!

It is our job to help our clients accomplish success even in the time of economic crisis. The success of our clients brings benefits to the overall community. Our main goal is to have a satisfied client, a client who will be more than happy to come to our premises and in a very short time be provided with good and full service.

We also aim at having satisfied employees of the bank, who will be coming to work in good mood and with the desire to make better results for each day. We want our employees to be proud of working with such a stable bank, which in the same time offers business challenges and the possibility of improving each and every day.

We also aim at having a satisfied shareholder who at the financial year-end will have a stable and profitable bank with an extensive base of performing clients, establishing thus a position in the banking market to also in the forthcoming years be achieving even better results.

Our Bank today is full with confidence and looks to the future with great optimism. We have managed to start everything that we announced a year ago in the field of business processes, and we continue building on the key platform on which we base our success.

We have successfully restructured the loan portfolio, managed to keep our conservative approach to credit risk and succeeded in saving all expenses to the maximum possible extent, while making sure that the system as a whole remains efficient and functional. We will continue paying great deal of attention in being economical, and this will remain our key character trait for the next year, regardless of our high profitability.

Also, another platform that we build our success on is our approach to clients and the quality of provided service processes. The introduction of a new sale system helped increase the speed and the quality of the service process also creating more room for direct communication with the customers.

We are a Bank recognized as a source of new ideas and content – and this is an image that we will try to keep in the next period. The strength of Hypo brand in the Republic of Srpska is still our great advantage and we intend to continue with strategic cultivating and development of our brand.

We are growing at a time of digital and social media that help us understand what the clients want from their bank and what the Bank can do to get closer to them in even more straightforward and responsible manner.

We are stronger than ever, and our competitive edge will only gain in intensity. We will continue working hard and intelligently, ensuring a promising future for our company.

However, we must not deceive ourselves with these successes and talk too much about them. We take these successes as additional obligation to in this and the following year become even better and stronger, more stable and more successful. To improve our services and bring them to a higher level and to create new products that will help our clients in reaching their goals and needs, to reduce any problems and deficiencies in our business operations to the minimum, in one word - to become the bank of first choice of each and every client in the Republic of Srpska.

Conclusion

Although a year full of challenges, the past year has proved to be above all successful. Our Hypo Bank Banja Luka is currently the biggest and the most profitable bank in the RS and one of the three most successful banks in BiH.

A result that one could only wish for!

For all this we are deeply indebted to our employees, who once again proved to be the bank's most valuable asset. Thanks to their dedication to work, our bank was able to pass from the crisis period to the level of record profitability. They showed to have been on top of their tasks, and we wish to especially thank them for their hard work throughout 2011. We owe our big gratitude to our clients, in particular our depositors, for their unwavering support and great confidence in us. We also wish to thank the Supervisory Board for their support, their trust and precious guidance.

We especially wish to thank the owner of Hypo Alpe Adria, that is to say, the Republic of Austria, for their huge support and the trust they have given us. Thanks to their unreserved support we managed to smoothly service the needs of more than 200 thousand our clients, in that way confirming a status of the leading bank in the domestic market.

It is our task to keep Hypo Bank profitable in the years and the decade to come, and to grasp at the opportunities offered by the trends of globalization, digitalization and urbanization of consumer society. At the same time, we need to remain faithful to responsible banking by giving financial support to our clients and to real economy. Looking in a short-term, the economic forecast for many world economies, including ours, remains rather grim. In a long-term, the strategy of our bank is set on the mentioned trends that we sincerely believe will define the future global and local economy.

Change in the composition of the Management Board

In 2011 the composition of the Bank's Management Board changed. Dragan Kovačević, a previous member of the Management Board, assumed a new duty as a Deputy Director in the Management Board of the sister bank Hypo Alpe-Adria-Bank d.d. Mostar.

Management Board Hypo-Alpe-Adria-Bank a.d. Banja Luka

Goran Babić
Executive Director

Samuel Vlčan
Director

Management Board Hypo-Alpe-Adria-Bank a.d. Banja Luka

Samuel Vlčan
Director

Areas of Responsibility:
Areas of Responsibility:
Board Assistance Team
Credit Management Department
Risk Controlling Department
Credit Processing Department
Rehabilitation Department
LTF Rehabilitation Department
Accounting Department
Financial Controlling Department
Corporate, PR/Marketing Department
Legal Department
Human Resources Department
Research and Chief Economist BiH Department
Retail Department
SME Department
Branch Coordination &Sales Steering
Collection Department
Product Management Department
Distribution Channel Management
Compliance Department
Operations Department
Logistics Department

Goran Babić
Executive Director

Areas of Responsibility:
Corporate Department
Public Department
Treasury Department

Basic Economic Indicators for Bosnia and Herzegovina

Overview of economic movements in 2011 with the projections for the next period

The process of the association with the European Union. After 16 months of political blockade, during which no government was formed at the state level and the negotiations between the political parties of the two Entities were carried through, resulting in, among other things, a delay of reforms necessary for the membership in the European Union, BH Council of Ministers was formed in February, thus fulfilling the basic preconditions for BiH to continue on the road of European integrations. The goal of the newly formed BiH CoM is to meet the conditions set by the European Union in the following few months and to apply for EU membership on 30 June 2012.

BiH credit rating for 2011

In May 2011, Moody's changed the B2 rating on Bosnia and Herzegovina from stable to negative. According to the Agency, this was caused by the political situation that prevailed at the time, constant delays in economic and constitutional reforms, as well as by an increased risk of further potential division of BiH possibly leading to delays in meeting the obligations based on issued state securities.

	Moody's Investors Service	Standard & Poor's
Rating	B2 / negative outlooks	B / on review – for downgrade
Date	16 May 2011	30 Nov 2011
Status	Outlook revised	Outlook revised

Source: CBBH, Moody's Investors Service, Standard & Poor's

The decision of Moody's was followed by the decision of Standard & Poor's-a at the end of July 2011, in which the outlooks for BiH rating were revised from stable to negative. All of this culminated in Standard & Poor's downgrading the sovereign credit rating on Bosnia and Herzegovina from „B+" to „B" on review – for downgrade, on 30 November 2011.

However, taking into account that the time of political instability is behind us, it is to be expected that the lowered credit rating on BiH will end in the next period.

After the year 2010 was marked by GDP's going out of the negative domain (0.7%), a certain economic recovery of the country continued in 2011, something that was noticeable through positive growth rates of both the export and the industrial production. We estimate that the GDP growth rate for 2011 will be at the level of about 1.0% (preliminary data indicate 1.8%). On the other hand, a combination of negative, internal and primarily external factors is expected to lead to new dwindling of economic activities in 2012 (-1.8%[1]).

The recovery of industrial production. At the end of 2011 the industrial production had a 5.6% growth (yoy[2]), mainly thanks to the mining and power sectors, or more precisely, increased demand and higher prices on export markets for aluminium and steel. Nevertheless, the existing crisis in the European monetary union and the problems prevailing in the West European markets which are the primary consumers of BH production have already begun leaving a mark on BH exporters. This is the main reason why we expect a decrease of the industrial production in 2012, at the rate of -2.7%[3].

Continuous growth of trade deficit. In 2011 the import rate was accelerated (14.0% in 2011 yoy compared to 13.7% in 2010 yoy, while the export decreased to 15.9% in 2011 yoy, compared to 28.8% in 2010 yoy.) The balance of trade worsened mainly due to increased import of crude oil and petroleum products, which is somewhat related to a recovery in the power sector, as well as to a considerable import of electricity. However, we believe that something that presents a bigger threat is slowing down of export of intermediate goods due to lower needs from abroad. We expect that export will continue to slow down due to the crisis in the European market, foreign fiscal consolidation and lower

1 The Department of Economic Research of Hypo Alpe-Adria-Bank a.d Banja Luka is in the process of revising the data and the projections. Revised projections will be available in regular publications of the Department.
2 (yoy) denotes a comparison of results of the current year with the resultf of the previous year, i.e. the annual growth
3 Ibid 1

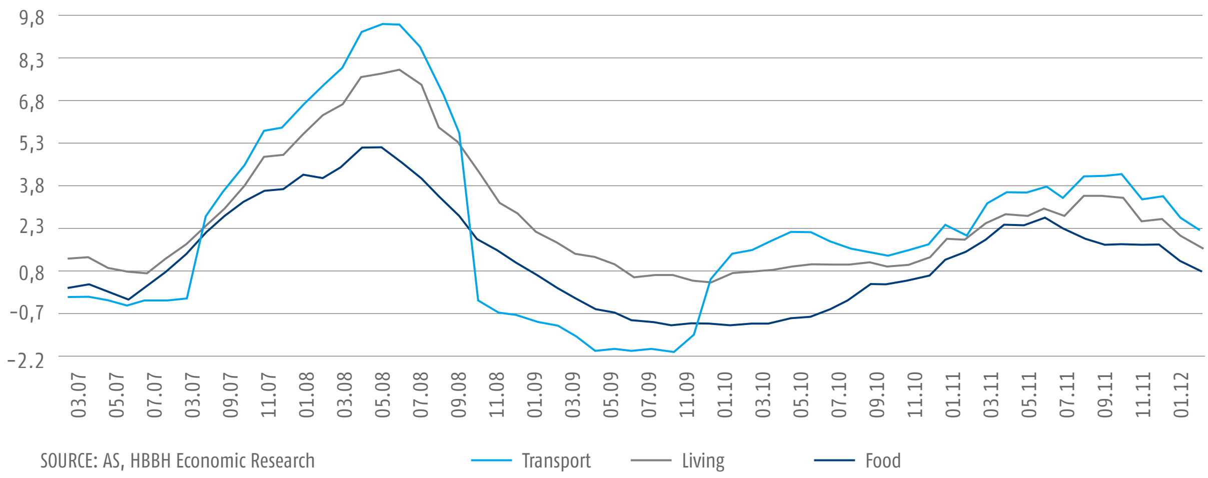
prices of goods and services. In addition to that, large export exposure toward Croatia and Italy, the countries that are already facing substantial economic problems, is also a matter of concern. On the other hand, we also expect a more considerable decrease of import caused by lower purchasing power and the lack of investment in capital assets.

The construction sector shows the signs of recovery. The value of performed construction works in BiH has grown by 26.9% (yoy) on the average. Although it may seem that a considerable progress was made in the sector in 2011, one thing to bear in mind is the effect of a comparison of the low base from the previous year as well as the fact that the recovery was not so visible in the construction sites themselves. The growth in the Republic of Srpska may be accounted for by an increase in the level of the activities on construction of roads, while the construction of residential buildings still stagnates, which can be explained by a reduced demand due to low purchasing power of citizens and possibly by more stringent lending conditions imposed by the banks. A standstill in the construction of big shopping centres, that partly helped sustain the construction sector, is also noticeable.

Continuing rise of the inflation. During 2011 the inflation had a 3.7% growth on the average compared to the same period of the last year. The growth in BiH was primarily affected by higher prices of food and crude oil in the world, increase in the level of excises on tobacco products, and higher costs of services in telecommunications, transport and housing.

We estimate that the inflation growth trend should decrease in the next year (2.4% yoy[4]) on the account of the mitigation of import inflationary pressures. In addition to this, the persisting weakness of domestic demand will keep the pressures on the demand side as a consequence of high unemployment, the existing amount of debt in households, increasing fiscal stringency and consumer pessimism. Another key additional risk that we see is presented by a possible increase in Value Added Tax (VAT).

CPI IN SEGMENTS %



SOURCE: AS, HBBH Economic Research

Negative trends in labour market. A decrease of the available income in households was mostly affected by a decrease of the real growth of net salaries at the level of 2.0% in BiH as well as by a decrease of cash receipts from

4 The Department of Economic Research of Hypo Alpe-Adria-Bank a.d Banja Luka is in the process of revising the data and the projections. Revised projections will be available in regular publications of the Department.

abroad. On the other hand, the unemployment rate rose from 27.2% in 2010 to 27.6% in 2011. The sectors that sustained a decrease of employment mainly included the construction sector, production sector and the service sector, while the sectors of financial mediation, transport and the public sector had an increase of the employed. A further unemployment growth trend is to be expected in 2012, with 29.9% rate, if the Governments choose to cut the number of employees in public administration. Moreover, the number of the employed in real sector is also expected to decrease, as a consequence of the past events, lack of the support of the state in creation of a better business environment. This can be expected taking into account a slow recovery of the economic growth on the one hand, and the conditions likely to be placed by the International Monetary Fund during the announced negotiations on the new arrangement with the IMF, on the other hand.

The requirement for mandatory reserve reduced. Decreasing the mandatory reserves of BH Central Bank by 4pp to 10% and releasing the additional 300 million KM of liquidity failed to produce the expected results. Although a certain reduction of funds with the CB was noticed, it is still obvious that the banks held much larger reserves than required. Commercial banks' lending to enterprises had a 2.8% growth in 2010, while lending to citizens increased by 6%. A partial increase in loans shows that the funds have been partly used to increase the companies' liquidity as well as to increase the consumption in households; the real effects will however be seen only once that the big investment projects are again in place.

Changed habits in consumers' behaviour. The effects of market volatility caused by global financial turmoil and the effects of lending expansion at the beginning of 2000s have also had their repercussions on the change of consumers' behaviour. The citizens proved to be more cautious when it comes to consumption, which also reflected in further growth of the total level of citizens' deposits in 2011, at the rate of 8.9% (yoy).

Growth of non-performing loans partly stopped. The problems of the banking sector concerning non-performing loans as a consequence of the effects of a lending boom from the previous years and continuous dwindling of the domestic economy, as well as of the reluctance on part of the local authorities to take more ambitious steps toward the implementation of the structural reforms to ensure fiscal and external sustainability, leading to the desired economic self-sustainability, persisted in 2011. These problems culminated in September, when the maximum 12.6% of non-performing loans compared to total loans extended in BH market was recorded. It was finally in the last quarter that the results of comprehensive efforts of the banks to harness their further growth became visible, so that the year ended at the level of 11.7% - this is certainly still a cause for concern, but also leaves an area for a hope that the situation with the non-performing loans will not further escalate during 2012.

Banking sector's return to the profitability area. Following a quite poor performance of the banking sector in 2010 (ROAE -5.5%), in 2011 the banks returned to the profitability area (ROAE 7.2%). Given the fact that no signs of considerable economic recovery have been noticed in the market, an increase in profitability can only be accounted for by the effects of restructuring of large banking groups, smaller willingness to take risk, i.e. increased care of the quality of assets and releasing a part of provisioning for credit risks accumulated during the previous years.

Securities trading

Banja Luka Stock Exchange (BLSE)

The total turnover at the Banja Luka Stock Exchange in 2011 reached the value of BAM 425.456.984 million, recording a growth of 141% yoy and with about 25.770 transactions. The growth was primarily a result of issuing the entities' treasury bills, and is also caused by a low comparison basis in 2010.

Security Designation	Issuer	Price on 31 Dec 2011	Average Price in December	No. of Trans.	Value (BAM)
TRZN-R-A	TRŽNICA AD BANJA LUKA	0,55	1,4943	813	22.885.729
RSRS-O-E	REPUBLIKA SRPSKA-Settlement of war damage 5	37,85	34,9714	3.624	7.865.254
TLKM-R-A	TELEKOM SRPSKE AD BANJA LUKA	1,46	1,6028	1.892	7.863.181
RSDS-O-C	REPUBLIKA SRPSKA-'frozen' old foreign currency savings 3	90,5	86,6903	483	6.419.517
RSRS-O-C	REPUBLIKA SRPSKA-settl. of war damage 3	39,48	37,7909	1.861	5.600.311
RSRS-O-D	REPUBLIKA SRPSKA-settl. of war damage 4	37,78	37,7267	1.527	3.957.842
ZPTP-R-A	ZIF ZEPTER FOND AD BANJA LUKA	5,89	6,0866	2.326	2.923.782
RSRS-O-A	REPUBLIKA SRPSKA-settl.of war damage 1	41,71	39,2911	987	2.556.327
HEDR-R-A	HIDROELEKTRANE NA DRINI AD VIŠEGRAD	0,499	0,6544	466	2.148.795
SODJ-R-A	JAHORINA OSIGURANJE AD PALE	370,37	352,1520	12	1.832.247
Other				11.564	28.856.903

BIRS (The Republic of Srpska Stock Exchange Index) fell by 8.34% (yoy) in 2011, while during the same period FIRS (RS Investment Funds Index RS) and ERS10 (The RS Power Utility Companies Index) grew by 11.61%, i.e. 9.8% (yoy).

Indices and market capitalization	Last day of the previous period	Last day of the period	% Change
Market capitalization	3.732.304.036 KM	3.835.425.219 KM	-0,65%
BIRS	956,12	876,36	-3,60%
FIRS	1.632,46	1.822,07	-12,45%
ERS10	801,34	874,10	8,42%

Treasury bills may be viewed as a novelty in our market, providing necessary support for the market recovery. Given that the entities' governments did not have access to international organizations' funds, they decided to procure part of necessary funds by issuing treasury bills. After the Republic of Srpska sold, in the local market, 64 million BAM through 6-month/9-month treasury bills in May/June, the Federation BiH Government sold 65 million BAM 6-month treasury bills at the price of 2.32% or +59bp at 6-month Euribor (as opposed to RS 76bp spread). The Republic of Srpska National Assembly has recently adopted a decision on long-term and short-term assuming of debt by the Republic of Srpska in the total amount of BAM 100 million through issuing of entity bonds and treasury bills for financing the entity's budget in 2012.

Sarajevo Stock Exchange (SASE)

Total turnover made on Sarajevo Stock Exchange in 2011 amounted to BAM 244.787.112,10 which is 36.97% of total turnover made on BH stock exchanges. The turnover made on SASE in 2011 is higher by 125.5% (yoy) compared to the turnover made in 2010. In 15.900 transactions, 56.693.439 securities were traded.

Issuer	Turnover	No.of transactions	% change of exchange rate
ZIF BIG Investiciona grupa dd Sarajevo	11.813.373,44 KM	1.394,00	19,40%
Opresa dd Sarajevo	8.657.959,92	3,00	2,80%
Fabrika duhana Sarajevo dd Sarajevo	5.630.453,52	1.743,00	-33,20%
BH Telecom d.d. Sarajevo	4.999.084,76	1.236,00	-3,44%
Bosnalijek d.d. Sarajevo	4.611.171,44	1.250,00	-42,09%
ZIF Herbos fond dd Mostar	3.908.261,51	158,00	-3,45%
ZIF MI Group dd Sarajevo	3.902.945,68	461,00	-2,14%
FBiH obveznice ratna potraživanja ser. A	3.613.740,23	286,00	7,69%
JP Elektroprivreda BIH dd Sarajevo	3.221.616,87	600,00	-36,31%
BOR BANKA DD SARAJEVO	2.711.379,90	29,00	0,00%

The value of Primary Free Market Index SASX-30 increased by 2.66% (yoy) compared to the last year. At the same time, the Investment Funds Index BIFX had an increase in value by 1.36% (yoy), while SASX-10 had a decrease of value by 16.18% (yoy).

Index	Last day of the previous period	Last day of the period	% Change
Market capitalization	7.210.603.026,80 KM	4.371.013.728,43	-39,38%
BIFX	1.520,80	1.541,52	1,36%
SASX-10	944,07	791,30	-16,18%
SASX-30	925,95	950,61	2,66%

Insurance

Insurance market in BiH is still quite undeveloped compared to the neighbouring countries and the developed countries. This fact has a lot to do with the reached level of development in BiH and hard living condition of most of the citizens of our country. The progress in the segment of insurance is evident, with visible increase in life insurances and improvement in legislation. However, the fact that the market is undeveloped still remains. Five biggest insurance companies hold almost 90% of the insurance market in BiH. In the sector of financial services BiH, the insurance companies' assets (as of December 2010[5]) accounted for 3.86% of the total assets.

Total premium in BiH in 2010 amounted to 472.008.481 KM, which is by 2.92% more than in 2009. A share of the companies with their seats in FBiH in total premium is at the level of 74.02%, while a share of the companies with seats in RS is 25.98%. Total profit of BH insurance and re-insurance companies in 2010 amounted to 24.723.791 KM, which is by 24,09% more compared to 2009. In the year 2010 in the RS insurance companies, generated profit amounted to 14.186.232 KM presenting a 366,22 % increase compared to 2009. Profit in FBiH insurance and re-insurance companies in 2010 amounted to 10.537.559 KM, showing a 34,35% decrease compared to 2009.

5 Reports for the year 2011 will not be available before August 2012.

Corporate Social Responsibility

For several years, Hypo Alpe-Adria-Bank a.d. Banja Luka has been working on adjusting its business operations with the best practices of developed countries in the world, which define social responsibility of the organization on the issue of relation to employees, clients and business associates, shareholders, local community and protection of environment. Although there are still no clear directives in BiH and RS related to organize way of reporting for commercial companies in domain of the Corporate Social Responsibility - CSR, Hypo Bank wishes to introduce all interested parties with basic activities it undertakes in the field of CSR.

Human Resources Management – HRM

Hypo Alpe-Adria-Bank a.d. Banja Luka, as member of multinational group working in several countries of the Alps-Adriatic region, is the employer fully dedicated to respecting individual values of each person regardless of his/her national, religious, race, gender or other civilization accepted differences. Hypo Bank, as the employer, fully respects and implements all positive legal regulations defining area of employment. All employees are employed fully and realize all legal rights upon annual leaves, sick leaves, personal earnings and contributions for health, social security, etc.

Also, the Bank enables employees to be engaged in sport and recreational activities through finance of lease in sports and recreational premises. All new employees go through organized training of acquaintance with the Bank, its vision, mission and strategy. All vacancies are fully adjusted to legal regulations and are always published in minimally 2 leading daily newspapers and the Bank's internet page. Adult-education process is constant, i.e. the Bank enabled employees to propose, in organized way, their education needs. The Bank, within its strong development in financial industry, organized, on annual level, series of seminars ad training sessions so bring employees to the latest knowledge in the aforementioned area.

In cooperation with employees, the Bank is doing annual report on self-assessment of each employee. The Bank ended 2011 with total of 509 employees, thus it is still the biggest employer in the RS financial industry.

Relationship to Customers and Business Associates

Hypo Alpe-Adria-Banka a.d. Banja Luka is deeply aware of the fact that loyal client is the biggest treasure of each financial institution bearing in mind the fact that business ethics takes very high place on the Bank's list of priorities.

The Bank intends to inform, on timely base, its clients and business associates on all changes related to its business, new products, services, interests, fee, commission, etc.

Also, through its marketing/PR actions, the Bank strictly complies with ethic code on truthfulness and factual state and it avoids any form of misleading client to make wrong conclusions through disinformation or inconsistencies in contents. In the field of customers' rights, the Bank has enabled organized way of filing complaints on quality of services, products and general relation of the Bank to its clients via introducing the position of the Client Complaints Officer. Clients are able to submit their objections, oral and written, in all Bank's Branch Offices or by post and e-mail, and to receive an official answer within the deadline of thirty days.

Hypo Bank was in particular demonstrating in practice its Corporate Social Responsibility in 2011 when it came out to meet the clients' needs, loan beneficiaries with foreign currency in the Swiss franc (CHF), by introducing a number of measures (extension of repayment term, fixing the exchange rate, reducing interest rates on housing loans, etc..) in order to make the process of repayment of loans easier for them due to the unpredictability of currency movements on the global financial markets. Hypo Bank will also in the future be guided by the principles of responsible banking with ethical and transparent business taking into account that the success of the Bank and its shareholders must be highly correlated with the success of its clients.

Relation to Local Community (Support to Culture, Art, Sports, Education and Health Public Institutions)

For many years, Hypo Bank has been supporting local communities, with significant funds form its budget, where it works through granting funds to education and health institutions and for events with goal to promote and preserve social values in the area of culture, art, non-commercial sports activities.

In 2011, Hypo Bank donated approximately 80.000,00 KM throughout RS. This money was donated to public institutions and associations of citizens taking care of children education and their health and social protection.

A special project of equipping schools with musical instruments has been successfully implemented in Trebinje, Istočno Sarajevo, Bijeljina, Brčko, and Prijedor. The most significant donation in the amount of 15 thousand BAM was given to the Academy of Arts Banja Luka/ Fine Arts Degree Program, University of Banja Luka, for equipping the graphic design studio.

Last year also, Hypo Bank was one of leading financial supporters of many cultural and artistic events as well as noncommercial sports activities in RS through many sponsorship activities.

Goal of Hypo Bank is to be part of local identity in each community where it works and that the same community and its citizens can count on Hypo Bank and its understanding within its limits. Children are priority as well as institutions taking care of their organized educational development, social and health protection.

Bodies of the Bank

SUPERVISORY BOARD:

Dipl. Kfm. MA Rainer Maria Sichert, Chairman
Mag. Wolfgang Mösslacher, Deeputy Chairman
Dr. Sebastian Firlinger, Member
Mag. Stephan Holzer, Member
Mag. Blaž Brodnjak, Member

MANAGEMENT BOARD:

Samuel Vlčan, Director
Goran Babić, Executive Director

AUDIT COMMITTEE

Đorđe Lazović, AC president
Andrea Castellarin, AC member
Maria Rauscher, AC member
Sandra Berdnik, AC member
Dejan Rajevac, AC member

INTERNAL AUDIT:

Slavica Vukelić

SHAREHOLDERS WITH 5% OR MORE SHARES WITH VOTING RIGHTS:

Hypo Alpe-Adria-Bank International AG, Klagenfurt

Organization Chart

Financial Statements

For the Year Ended December 31, 2011 and Independent auditors' Report

Deloitte d.o.o. Banja Luka
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Bosnia and Herzegovina

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Translation of the Auditors' Report issued in the Serbian language

INDEPENDENT AUDITORS' REPORT

To the Supervisory Board and Shareholders of Hypo Alpe-Adria-Bank a.d., Banja Luka

We have audited the accompanying financial statements (pages 2 to 64) of Hypo Alpe-Adria Bank a.d., Banja Luka (the "Bank"), which comprise the balance sheet as of December 31, 2011 and the related income statement, statement of changes in equity and cash flow statement for the year than ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements in accordance with the accounting regulations of the Republic of Srpska and regulations of the Banking Agency of the Republic of Srpska governing financial reporting of banks, as well as for internal control relevant to the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

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 and the Law on Accounting and Auditing of the Republic of Srpska. 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 entity'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 entity'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.

Opinion

In our opinion, the financial statements of Hypo Alpe-Adria Bank a.d., Banja Luka as of and for the year ended December 31, 2011 have been prepared, in all material respects, in accordance with the accounting regulations of the Republic of Srpska and regulations of the Banking Agency of the Republic of Srpska governing financial reporting of banks, as well as with the basis of preparation of the financial statements and accounting policies disclosed in Notes 2 and 3 to the financial statements.

Other Matter

The financial statements of the Bank as of and for the year ended December 31, 2010 were audited by another auditor whose report dated March 7, 2011 expressed an unmodified opinion.

Banja Luka, March 23, 2012

DELOITTE D.O.O. 1 BANJA LUKA

Certified Auditor
Žarko Mionić

Income Statement

Year Ended December 31, 2011 (Thousands of BAM)

	Notes	Year Ended December 31, 2011	Year Ended December 31, 2010
Interest income		84,693	92,840
Interest expense		(40,325)	(40,247)
Net interest income	**6**	**44,368**	**52,593**
Fee and commission income		13,255	12,401
Fee and commission expense		(4,146)	(3,646)
Net fee and commission income	**7**	**9,109**	**8,755**
Foreign exchange gains, net		1,536	3,700
Other operating income	8	17,380	10,773
Other operating expenses	9	(45,534)	(49,821)
PROFIT BEFORE IMPAIRMENT LOSSES, PROVISIONS AND INCOME TAX		**26,859**	**26,000**
Provisions for potential losses, contracted liabilities and write-offs	10	(762)	(71,426)
PROFIT/(LOSS) BEFORE TAXATION		**26,097**	**(45,426)**
Income tax expenses	11	(2,854)	(3,224)
NET PROFIT/(LOSS) FOR THE YEAR		**23,243**	**(48,650)**
Total comprehensive income			
Revaluation of property and investment property		-	801
(Loss)/profit on financial instruments available-for-sale		(16)	1
Other losses recognized within equity		(689)	(3)
Income tax relating to components of other comprehensive income		-	(80)
TOTAL COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR		**22,538**	**(47,931)**
Earnings per share (in BAM)	27	0.145	(0.383)

The accompanying notes form an integral part of these financial statements.

These financial statements were approved by management of Hypo Alpe-Adria Bank a.d., Banja Luka on February 21, 2012.

Signed on behalf of the Bank by:

Goran Babić
Executive Director

Samuel Vlčan
Director

Balance Sheet

As of December 31, 2011 (Thousands of BAM)

	Notes	December 31, 2011	December 31, 2010
ASSETS			
Cash and balances with the Central Bank	12	245,434	169,699
Deposits with banks	13	16,337	28,829
Loans and advances to customers	14	1,096,453	1,243,920
Securities available-for-sale	15	15,454	1,080
Equity investments	16	2,500	-
Property and equipment	17	47,568	49,323
Intangible assets	18	13,364	12,642
Investment property	19	3,556	3,610
Other assets	20	7,421	6,635
Total assets		**1,448,087**	**1,515,738**
LIABILITIES			
Deposits held by banks and other financial institutions	21	440,921	560,964
Customers' deposits	22	543,320	521,540
Borrowings	23	146,261	150,911
Subordinated liabilities	24	35,470	35,470
Other liabilities	25	38,981	26,927
Other provisions	28	8,999	8,301
Total liabilities		**1,213,952**	**1,304,113**
EQUITY			
Share capital	26	129,168	175,512
Share premium		-	64
Reserves		74,743	74,317
Revaluation reserves		6,760	7,689
Retained earnings / (Accumulated losses)		23,464	(45,957)
Total equity		**234,135**	**211,625**
Total liabilities and equity		**1,448,087**	**1,515,738**
COMMITMENTS AND CONTINGENT LIABILITIES	29	**115,410**	**113,008**

The accompanying notes form an integral part of these financial statements.

Statement of Changes in Equity

Year Ended December 31, 2011 (Thousands of BAM)

	Share Capital	Share Premium	Reserves	Revaluation Reserves	(Accumulated Losses)/ Retined Earnings	Total
Balance, December 31, 2009	**125,837**	**64**	**73,855**	**7,183**	**2,942**	**209,881**
Distribution of profit from the year 2010	-	-	465	-	(465)	-
New issue of shares	49,675	-	-	-	-	49,675
Revaluation of property and investment properties	-	-	-	585	216	801
Revaluation of securities available-for-sale	-	-	-	1	-	1
Other losses recognized within equity	-	-	(3)	-	-	(3)
Effect of changes in the deferred taxes, net	-	-	-	(80)	-	(80)
Net loss for the year 2010	-	-	-		(48,650)	(48,650)
Balance, December 31, 2010	**175,512**	**64**	**74,317**	**7,689**	**(45,957)**	**211,625**
Absorption of the loss for the year 2010	(46,344)	(64)	423	-	45,957	(28)
Amortization of revaluation reserves of properties and investment properties	-	-	-	(221)	221	-
Revaluation of securities available-for-sale	-	-	-	(16)	-	(16)
Other losses recognized within equity	-	-	3	(692)	-	(689)
Net profit for the year 2011	-	-	-	-	23,243	23,243
Balance, December 31, 2011	**129,168**	**-**	**74,743**	**6,760**	**23,464**	**234,135**

The accompanying notes form an integral part of these financial statements.

Cash Flow Statement

Year Ended December 31, 2011 (Thousands of BAM)

	Notes	Year Ended December 31, 2011	Year Ended December 31, 2010
Cash flows from operating activities			
Interest, fee and commission receipts		101,509	105,074
Interest paid		(41,440)	(42,542)
Collected receivables on loans previously written-off		12,493	9,732
Payments to, and on behalf of employees and accounts payable		(36,150)	(31,780)
Off-balance sheet contractual payments		89	(8)
Receipts and payments on extraordinary items		10,276	775
Loans and advances to customers		142,721	30,740
Customers' deposits		(98,443)	(152,094)
Income taxes paid		(3,405)	(3,365)
Net cash used in operating activities		**87,650**	**(83,468)**
Cash flows from investing activities			
Interest receipts		7	8
Dividend receipts		-	114
Sale/(purchase) of securities available-for-sale		-	26
Collectible securities available-for-sale		25	-
Investment in securities available-for- sale		(14,634)	-
Purchase of intangible assets		(1,243)	(6,819)
Purchase of property and equipment		(1,282)	(1,172)
Sale of equity investment in subsidiaries		81	-
Purchase of equity investment in subsidiaries		(2,500)	-
(Purchase)/sale of other investments		450	(255)
Net cash used in investing activities		**(19,096)**	**(8,098)**
Cash flows from financing activities			
Proceeds from shares issued		-	49,646
Interest paid for borrowings		(3,175)	(2,881)
Borrowings received		13,570	26,233
Repayment of borrowings		(17,984)	(11,350)
Dividend payments		(1)	(15)
Net cash used in financing activities		**(7,590)**	**61,633**
Net increase/(decrease) in cash and cash equivalents		**60,964**	**(29,933)**
Cash and cash equivalents at beginning of year		**198,495**	**224,131**
Foreign exchange effects		2,281	4,297
Cash and cash equivalents at end of year	**12, 13**	**261,740**	**198,495**
Cash and cash equivalents comprise the following balance sheet components:			
Cash and balances with the Central Bank	12	245,434	169,699
Deposits with banks	13	16,337	28,829
Less: interest accrued and provisions		(31)	(33)
		261,740	**198,495**

The accompanying notes form an integral part of these financial statements.

Notes to the Financial Statements

Year Ended December 31, 2011

1. General Information

Hypo Alpe-Adria-Bank A.D., Banja Luka (the "Bank") is a legal successor of Kristal Banka A.D., Banja Luka which was initially registered as a separate legal entity on September 30, 1992, and subsequently transformed into a shareholders' company on May 16, 1997. Prior to its establishment as an independent bank, the Bank operated as a main branch of Jugobanka Jubanka d.d., Sarajevo, a related party of Jugobanka d.d., Beograd. Based on the decision of the Banja Luka Court (number U/I 2308/03) dated October 9, 2003, the Bank commenced its operations under its current registered name.

The Bank is 99.73% owned by Hypo Alpe-Adria-Bank International AG, Klagenfurt, Austria, and member of the Hypo Alpe-Adria Group. Ultimate parent of the Bank until the end of 2009 was Bayern LB, Germany. On December 30, 2009, the ultimate parent of the Bank became Republic of Austria, with 100% ownership of Hypo Alpe-Adria-Bank International AG. Please refer to Note 26 for further information.

The Bank is licensed in the Republic of Srpska to perform banking operations related to payment transfers, credit and deposit activities in the country and abroad, and in accordance with the Republic of Srpska banking legislation, it is to operate based on the principles of liquidity, solvency and profitability.

The Bank's registered head office is in Aleja Svetog Save 13, Banja Luka, Republic of Srpska. As of December 31, 2011, besides the head office located in Banja Luka, the Bank had 43 branch offices situated throughout Bosnia and Herzegovina (BiH), (December 31, 2010: the head office located in Banja Luka and 41 branch offices).

As at December 31, 2011, the Bank had 509 employees (2010: 517 employees).

Management	
Director from May 31, 2010	Samuel Vlčan
Executive Director from May 31, 2010 and Deputy Director from October 1, 2010 to December 15, 2011	Dragan Kovačević
Executive Director from May 31, 2010	Goran Babić
Supervisory Board	
President from September 20, 2010	Dipl. Kfm. MA Rainer Maria Sichert
Vice President from May 27, 2010	Mag. Wolfgang Mösslacher
Member from March 23, 2011	Dr. Sebastian Firlinger
Member from May 27, 2010	Mag. Stephan Holzer
Member from March 23, 2011	Mag. Blaž Brodnjak
Member from March 23, 2011	Mag. Patrick Luger
Member from March 23, 2011	Mag Ružica Topić

Audit Committee	
President from May 29, 2011	Đorđe Lazović
Member from May 29, 2011	Castellarin Andrea
Member from May 29, 2011	Jaeger-Letzl Sabine
Member from May 29, 2011	Milunović Thomas
Member from May 29, 2011	Rauscher Maria
President up to May 29, 2011	Mag. Dr. Hans-Dieter Kerstnig
Member up to May 29, 2011	Nensi Marin
Member up to May 29, 2011	Zoran Besak
Member up to May 29, 2011	Besna Pavlović
Member up to May 29, 2011	Danijel Gregorić

2. Basis for Preparation and Presentation of the Financial Statements and Accounting method

2.1. Basis of Preparation and Presentation of Financial Statements

The Bank's financial statements have been prepared in accordance with the accounting regulations effective in the Republic of Srpska.

The Bank's financial statements as of December 31, 2011 have been prepared in compliance with Article 14 of the Law on Banks (Official Gazette of the Republic of Srpska no. 44/03) and regulations of the Banking Agency of the Republic of Srpska (BARS).

The accompanying financial statements are the annual stand-alone (unconsolidated) financial statements of the Bank. As disclosed in Note 16, Hypo Alpe-Adria-Bank a.d., Banja Luka is a Parent company of a business group, where another member is Hypo Alpe-Adria leasing d.o.o., Banja Luka. Investments in subsidiaries are stated at cost in these financial statements, net of any accumulated impairment. According to International Accounting Standard (IAS) 27 "Consolidated and Separate Financial Statements," the Bank will prepare its consolidated financial statements for the year 2011 no later than April 30, 2012, as in accordance with International Financial Reporting Standards.

These financial statements have been prepared at cost principle except for the revaluation of certain financial instruments measured at fair value as explained in the accounting policies provided in the following passages.

The accompanying financial statements have been prepared by applying International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) which were in effect at January 1, 2009 and in accordance with accounting regulations of the Republic of Srpska based on these standards. Namely, in accordance with the provisions of the Law on Accounting and Auditing of the Republic of Srpska, currently in force, (Official Gazette of RS numbered 36/09), all legal entities situated on the territory of the Republic of Srpska are under an obligation to fully apply IAS, IFRS and International Standards on Auditing (ISA), as well as the Code of Ethics for Professional Accountants and the pronouncements, interpretations and guidelines of the International Accounting Standards Board (IASB) and all pronouncements, interpretations and guidelines of the International Federation of Accountants (IFAC) to its financial statements prepared for the periods commencing on or after January 1, 2010.

Regulations, Standards and Interpretations in Effect in the Period

In addition, on July 15, 2010, the Management Board of the Association of Accountants and Auditors of the Republic of Srpska ("AAARS") enacted the "Decision on the Commencement of the Mandatory Application of IAS/IFRS Issues (published until January 1, 2009)" based on the "Decision on the Authorizations for Translation and Issuance" of the concerned Accounting and Auditing Commission of Bosnia and Herzegovina dated March 10, 2006 (Official Gazette of BIH number 81/06), granting such authorizations to the AAARS. The aforementioned issue of IAS/IFRS was approved by the International Accounting Standards Committee Foundation as the official translation into the Serbian language for Bosnia and Herzegovina (Republic of Srpska), Serbia and Montenegro. Pursuant to the aforementioned Decision, IAS/IFRS published until January 1, 2009 are mandatorily applied to the financial statements prepared and presented in the Republic of Srpska for the accounting periods commencing on or after January 1, 2010.

However, the amendments to the standards and interpretations in effect, as well as newly adopted standards and interpretations issued after January 1, 2009, have not been issued and officially adopted in the Republic of Srpska and therefore, not applied in the preparation of the accompanying financial statements. Standards and interpretations in issue, but not yet officially translated and adopted and standards and interpretations in issue but not yet in effect are disclosed in Notes 2.2 and 2.3.

In addition to the aforementioned matters, the accounting regulations of the Republic of Srpska applied in preparation of the financial statements as of and for the year ended December 31, 2011 depart from the requirements of IFRS and IAS, in the following materially significant aspects of financial reporting:

- Based on the Guidelines on the Form and Contents of the Balance Sheet and Income Statement Items for Banks and Other Financial Organizations (Official Gazette of RS no. 67/09), loan origination fees are included within "fee and

2. Basis for Preparation and Presentation of the Financial Statements and Accounting method (continued)

commission income“ and not within effective interest rate account as required by IAS 18 “Income“ and IAS 39 “Unconsolidated Financial Instruments: Recognition and Measurement“;

- Based on the Guidelines on the Form and Contents of the Balance Sheet and Income Statement Items for Banks and Other Financial Organizations (Official Gazette of RS no. 67/09), interest receivables are stated within calculated interest accrued and other assets, and not within loans and advances to customers, as required by IAS 39 “Unconsolidated Financial Instruments: Recognition and Measurement“; and
- Based on the Guidelines on the Form and Contents of the Balance Sheet and Income Statement Items for Banks and Other Financial Organizations (Official Gazette of RS no. 67/09), interest payables are stated within Other liabilities, and not within borrowings, as required by IAS 39 “Unconsolidated Financial Instruments: Recognition and Measurement“.

Given the aforesaid, the Bank reclassified certain amounts in the accompanying balance sheet and income statement forms in order to eliminate the differences between the Guidelines on the Form and Contents of the Balance Sheet and Income Statement Items for Banks and Other Financial Organizations (Official Gazette of RS no. 67/09) and the requirements of IFRS and IAS, as follows:

- Interest receivables have been reclassified to loans and cash and cash equivalents, i.e. to the items they originated from;
- Interest payables have been reclassified to deposits due and borrowings, i.e. to the items they originated from;
- Loan origination fee income has been reclassified to interest income; and
- Income and expenses from increase or decrease in provisions have been reclassified in part to other operating income and other operating expenses.

In addition to the aforesaid, the Bank duly prepared the balance sheet and income statement forms up to the prescribed deadline and in the manner defined by the Guidelines on the Form and Contents of the Balance Sheet and Income Statement Items for Banks and Other Financial Organizations (Official Gazette of RS no. 67/09), and submitted them to the Agency for Intermediary, IT and Financial Services in Banja Luka, as the competent control authority on February 29, 2012.

The amounts in the accompanying financial statements are stated in thousands of Convertible marks (BAM).

The Convertible marks (BAM) is the functional and reporting currency of the Republic of Srpska and Bosnia and Herzegovina.

In the preparation of the statement of cash flows for the year 2011, the Bank applied direct method in reporting on cash flows.

In the preparation of the accompanying financial statements, the Bank adhered to the accounting policies described in Note 3 to the financial statements, based on the accounting and taxation regulations of the Republic of Srpska.

2.2. Standards and Interpretations in Issue not yet Translated and Adopted in the Republic of Srpska

At the date of issuance of these financial statements the following standards, revisions and amendments were issued by IASB and the following interpretations published by IFRIC, but not yet officially adopted in the Republic of Srpska for the annual periods beginning on or after January 1, 2011:

- Amendments to IFRS 7 “Financial Instruments: Disclosures” – Amendments improving fair value and liquidity risk disclosures (revised in March 2009, effective for annual periods beginning on or after January 1, 2009);
- Amendments to IAS 38 “Intangible Assets” (revised in July 2009, effective for annual periods beginning on or after July 1, 2009);
- Amendments IFRIC 9 “Reassessment of Embedded Derivatives” effective for annual periods beginning on or after July 1, 2009 and IAS 39 “Financial Instruments: Recognition and Measurement” – Embedded Derivatives (effective for annual periods beginning on or after June 30, 2009);
- IFRS 1 (revised) “First-time Adoption of IFRS” (effective for annual periods beginning on or after July 1, 2009);
- IFRS 3 (revised) “Business Combinations” (effective for annual periods beginning on or after July 1, 2009);

2. Basis for Preparation and Presentation of the Financial Statements and Accounting method (continued)

- Amendments to IFRS 1 "First-time Adoption of IFRS" – Additional Exemptions for First-time Adopters of IFRS (effective for annual periods beginning on or after January 1, 2010);
- Amendments to IFRS 2 "Share-based Payment": Amendments resulting from the Annual quality improvement project of IFRS (revised in April 2009, effective for annual periods beginning on or after July 1, 2009) and amendments relating to group cash-settled share-based payment transactions (revised in June 2009, effective for annual periods beginning on or after January 1, 2010);
- Amendments to IAS 27 "Consolidated and Separate Financial Statements" (effective for annual periods beginning on or after July 1, 2009);
- Amendments to IAS 39 "Financial Instruments: Recognition and Measurement" – Eligible Hedged Items (effective for annual periods beginning on or after July 1, 2009);
- Amendments to various standards and interpretations resulting from the Annual quality improvement project of IFRS published on April 16, 2009 (IFRS 2,IFRS 5, IFRS 8, IAS 1, IAS 7, IAS 17, IAS 18, IAS 36, IAS 38, IAS 39, IFRIC 9, IFRIC 16) primarily with a view to removing inconsistencies and clarifying wording, (amendments are to be applied for annual periods beginning on or after January 1, 2010, while the amendment to IFRIC is to become effective as of July 1, 2009);
- IFRIC 17 "Distributions of Non-Cash Assets to Owners" (effective for annual periods beginning on or after July 1, 2009);
- IFRIC 18 "Transfers of Assets from Customers" (effective for annual periods beginning on or after July 1, 2009);
- "Conceptual Framework for Financial Reporting 2010" being an amendments to "Framework for the Preparation and Presentation of Financial Statements" (effective from publication on or after September 2010);
- Amendments to IFRS 1 "First-time Adoption of IFRS" – Limited Exemption from Comparative IFRS 7 Disclosures for First-time Adopters (effective for annual periods beginning on or after July 1, 2010);
- Amendments to IAS 24 "Related Party Disclosures" – Simplifying the disclosure requirements for government-related entities and clarifying the definition of a related party (effective for annual periods beginning on or after January 1, 2011);
- Amendments to IAS 32 "Financial Instruments: Presentation" – Accounting for rights issues (effective for annual periods beginning on or after February 1, 2010);
- Amendments to various standards and interpretations resulting from the Annual quality improvement project of IFRS published on May 6, 2010 (IFRS 1, IFRS 3, IFRS 7, IAS 1, IAS 27, IAS 34, IFRIC 13) primarily with a view to removing inconsistencies and clarifying wording, (most amendments are to be applied for annual periods beginning on or after January 1, 2011);
- Amendments to IFRIC 14 "IAS 19 – The Limit on a defined benefit, Minimum Funding Requirements and their Interaction" – Prepayments of a Minimum Funding Requirement (effective for annual periods beginning on or after January 1, 2011); and
- IFRIC 19 "Extinguishing Financial Liabilities with Equity Instruments" (effective for annual periods beginning on or after July 1, 2010).

2.3. Standards and Interpretations in Issue not yet in Effect

At the date of issuance of these financial statements the following standards, revisions and interpretations were in issue but not yet effective:

- IFRS 9 "Financial Instruments" (effective for annual periods beginning on or after January 1, 2015);
- IFRS 10 "Consolidated Financial Statements" (effective for annual periods beginning on or after January 1, 2013);
- IFRS 11 "Joint Arrangements" (effective for annual periods beginning on or after January 1, 2013);
- IFRS 12 "Disclosures of Involvement with Other Entities" (effective for annual periods beginning on or after January 1, 2013);

2. Basis for Preparation and Presentation of the Financial Statements and Accounting method (continued)

- IFRS 13 "Fair Value Measurement" (effective for annual periods beginning on or after January 1, 2013);
- IAS 27 (revised in 2011) "Separate Financial Statements" (effective for annual periods beginning on or after January 1, 2013);
- IAS 28 (revised in 2011) "Investments in Associates and Joint Ventures" (effective for annual periods beginning on or after January 1, 2013);
- Amendments to IFRS 1 "First-time Adoption of IFRS"- Severe Hyperinflation and Removal of Fixed Dates for First-time Adopters (effective for annual periods beginning on or after July 1, 2011);
- Amendments to IFRS 7 "Financial Instruments: Disclosures" – Transfers of Financial Assets (effective for annual periods beginning on or after July 1, 2011);
- Amendments to IFRS 7 "Financial Instruments: Disclosures" – Offsetting Financial Assets and Financial Liabilities (effective for annual periods beginning on or after January 1, 2013);
- Amendments to IFRS 9 "Financial Instruments" and IFRS 7 "Financial Instruments: Disclosures" – Mandatory Effective Date and Transition Disclosures;
- Amendments to IAS 1 "Presentation of Financial Statements" – Presentation of Items of Other Comprehensive Income (effective for annual periods beginning on or after July 1, 2012);
- Amendments to IAS 12 "Income Taxes" – Deferred Tax: Recovery of Underlying Assets (effective for annual periods beginning on or after January 1, 2012);
- Amendments to IAS 19 "Employee Benefits" – Improvements to the Accounting for Post-employment Benefits (effective for annual periods beginning on or after January 1, 2013);
- Amendments to IAS 32 "Financial Instruments: Presentation" – Offsetting Financial Assets and Financial Liabilities (effective for annual periods beginning on or after January 1, 2014);
- IFRIC 20 "Stripping Costs in the Production Phase of a Surface Mine" (effective for annual periods beginning on or after January 1, 2013).

3. Summary of Significant Accounting Policies

3.1 Basis of Measurement

These financial statements have been prepared under the historical cost convention, as modified by the revaluation of buildings, trading securities carried at fair value through profit or loss and available-for-sale securities.

3.2 Interest Income and Expense

Interest income and expense for all interest-bearing financial instruments are recognized within interest income and interest expense in the income statement. Interest income and expense are accounted for on an accrual basis.

Fee and commission income, except for loan origination fees, are recognized in full when earned.

Fees relating to loan origination are deferred and amortized over the life of the loan using the effective interest rate method.

The effective interest rate method is a method that calculates the costs of repayment of financial assets or financial liabilities and the costs of recognition of interest income or interest expense over a period. The effective interest rate is the rate that precisely discounts estimated future payments or receipts through the expected life of the financial instruments or, when appropriate, in shorter period to the net carrying value of financial assets or financial liabilities. When effective interest rate is calculated, the Bank estimates cash flows considering all contractual terms of the financial instrument (for example, the possibility of paying in advance), but does not consider future credit losses. The calculation includes all fees and amounts paid or received between two parties that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

3. Summary of Significant Accounting Policies (continued)

3.3. Fee and Commission Income and Expense

Fees and commissions are generally recognized on an accrual basis when due for collection i.e. when the service has been rendered.

Fee and commission income relate to local payments and international payments operations, income from off- balance sheet operations (guarantee issuance), brokerage and dealing operations etc.

Fee and commission expenses relate to fees paid to the Central Bank of Bosnia and Herzegovina for the local payments operations, SWIFT costs, costs of payment card operations, fees paid to the Banking Agency of Republic of Srpska for supervision of the banking sector and other fees (Note 7b).

3.4. Foreign Exchange Translation

Functional and Presentation Currency

Items included in the financial statements are measured using the currency of the primary economic environment in which the Bank operates ('the functional currency').

The financial statements are presented in BAM which is the Bank's functional and presentation currency.

Transactions and Balances

Transactions denominated in foreign currencies are translated into BAM at official rates effective at the date of each transaction. Assets and liabilities denominated in foreign currencies on the balance sheet date are translated into BAM by applying official rates of exchange valid on that date. Contingent liabilities denominated in foreign currencies are translated into BAM at official exchange rates effective at the balance sheet date.

Foreign exchange gains or losses arising from translation are credited or charged to the income statement. The Bank does not have monetary securities denominated in foreign currency.

Exchange rates used in these financial statements are official rates established by the Central Bank of Bosnia and Herzegovina ("CBBH").

3.5. Property and Equipment

Property and equipment are carried at their fair value, as determined by certified appraisers, subsequently decreased by the accumulated depreciation.

A revaluation of the Bank's property was performed by an independent certified appraiser as of December 31, 2010 based on the assets' market value for existing use.

Subsequent costs are included in the asset's carrying amount or recognized 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.

Increases in the carrying amount arising on revaluation of buildings and equipment are credited to equity as revaluation reserve. The increase is recognized in the income statement only to the extent that it reverses a revaluation decrease of the same asset previously recognized in profit or loss. If an asset's carrying amount is decreased as a result of a revaluation, the decrease is recognized in the income statement. The decrease is debited directly to revaluation reserve within equity to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

Revaluation reserves included in equity in respect of property and equipment are transferred directly to retained earnings when the asset is derecognized. This may involve transferring the whole of the surplus when the asset is retired or disposed of.

Land is not depreciated. Depreciation on other assets is calculated using the straight - line method to allocate their cost or revaluated amounts to their residual values over their estimated useful lives:

3. Summary of Significant Accounting Policies (continued)

	Depreciation Rate	Useful Life (years)
Buildings	1.33%-2.86%	35-75
Computer equipment	12.5%-20%	5-8
Furniture and other equipment	6.67% -33.33%	3-15
Vehicles	20% - 25%	4-5

The Bank's management believes that depreciation rates applied fairly reflect the economic useful life of property and equipment.

Gains and losses on disposals are determined by comparing the proceeds with the carrying amount and are recognized within gains or losses from sale of property and equipment.

3.6. Intangible assets

Intangible assets include computer software and licenses. The initial cost of acquisition of assets is amortized on a straight-line basis, as follows:

	Amortization Rate	Useful Life (years)
Intangible assets	14.29% - 20%	5-7

3.7. Investment Property

Investment property, which is property held to earn rentals, is carried at fair value, as determined by certified appraisers, subsequently decreased by the accumulated depreciation. The cost of purchased investment property comprises its purchase price, and any directly attributable expenditure.

Gains and losses on disposals are determined by comparing the proceeds with the carrying amount and are recognized within gains or losses from sale of investment property.

3.8. Impairment of Non-Financial Assets

Assets that are subject to depreciation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use.

3.9. Financial Assets

The Bank classifies allocates financial assets into the following categories: financial assets at fair value through profit or loss; loans and receivables; held-to-maturity investments; and available-for-sale financial assets. Management determines the classification of financial instruments at initial recognition.

As of December 31, 2011 the Bank has only loans and receivables and available-for-sale financial assets.

Loans and Receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.

3. Summary of Significant Accounting Policies (continued)

Financial Assets Available-for-Sale
Financial assets available for sale are those assets where intention is to be held for undefined period that can be sold in line with need for liquidity or changes in interest rate, exchange rates or change in price of capital.

The Accounting Treatment
Regular purchases and sales of financial assets at fair value through profit or loss, assets held to maturity and the assets available for sale are recognized on the transaction date and the date on which the Bank commits to purchase or sell the asset. Investments are initially recognized at fair value increased by transaction costs for all financial assets not carried at fair value through profit or loss. Financial resources are derecognized from the books at a time when the Bank has transferred substantially all the risks and rights arising from ownership or when the expiration of the right bank to receive cash flows arising from financial assets.

Available-for-sale financial assets are subsequently recognized at fair value. Loans and receivables as well as held to maturity are measured at amortized cost using the effective interest rate method. Gains or losses arising from fair value adjustments of financial assets carried at fair value through profit and loss, are recognized in the income statement in the period when incurred. Gains and losses arising from fair value adjustments of financial assets available for sale are directly stated in equity, until their disposal or impairment charges, when the cumulative income or expense previously recognized in equity is recognized in the income statement. However, interest calculated using the effective interest rate method, is recognized in the income statement. Dividends are recognized in the statement of comprehensive income when the entity's right to receive payment is established.

The fair value of securities that are listed are based on current bid prices. If the market for a financial asset (the market of securities which are not listed) is not active, the Bank establishes fair value by assessment techniques. It involves the application of recent transactions between independent parties, reference to other instruments that are substantially the same, discounted cash flow analysis and other valuation techniques.

Impairment of Financial Assets
The Bank assesses at each reporting date whether there is objective evidence that a financial asset or group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. The criteria that the Bank uses to determine that there is objective evidence of an impairment loss include:

- delays in payment of the agreed repayment of principal or interest;
- difficulty with cash flows experienced by the debtor (capital indicators, the percentage of net sales);
- violation of contractual obligations;
- initiation of bankruptcy proceedings;
- deterioration of the debtor's competitive position;
- decrease in value of collateral.

The estimated period between a loss occurring and its identification is determined by the management for each identified portfolio. In general, the periods vary between three and twelve months; in exceptional cases, longer periods are warranted.

The Bank first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If the Bank determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for

3. Summary of Significant Accounting Policies (continued)

impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognized are not included in a collective assessment of impairment.

The amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognized in the trought income statement.

The calculation of the present value of the estimated future cash flows of a collateralized financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics (e.g., on the basis of the Bank's grading process that considers asset type, industry, geographical location, collateral type, past-due and outstanding loans status and other relevant factors). Those characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the Bank and historical loss experience for assets with credit risk characteristics similar to those in the Bank. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not currently exist.

Estimates of changes in future cash flows for groups of assets should reflect and be directionally consistent with changes in related observable data from period to period (for example, changes in unemployment rates, property prices, payment status, or other factors indicative of changes in the probability of losses in the Bank and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Bank to reduce any differences between loss estimates and actual loss experience.

When a loan is uncollectible, it is written off against the related allowance for loan impairment. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized (such as an improvement in the debtor's credit rating), the previously recognized impairment loss is reversed by adjusting the allowance account. The amount of the reversal is recognized in the income statement.

Estimation of Potential Losses for Financial Assets in Accordance with the Requirements of the Banking Agency of the Republic of Srpska

In accordance with the Decision of the Banking Agency of the Republic of Srpska classification of assets and off balance sheet items according to the degree of collectability, the Bank is required to classify loans, placements and other balance sheet and off-balance sheet exposure to the Bank's risk in categories A, B, C, D and E in accordance with the assessment of recoverability of loans and other placements based on the timeliness of settling the obligation of the debtor, debtor's financial position and collateral receivables. Estimated amount of reserves for potential losses were calculated using the following percentages: 2% on loans classified as category A, 5% - 15% of the loans in category B, 16% - 40% on loans in category C, 41 - 60% on loans in category D and 100% placements in category E.

The difference between allowances determined in the manner and estimated provisions for potential losses on loans classified into categories described above, is recorded in the provision account, included in statutory reserves, in equity and allocation of these provisions is made from retained earnings up to the level of retained earnings. A Bank cannot use these provisions to cover losses, but must disclose a shortfall.

3. Summary of Significant Accounting Policies (continued)

Assets classified as Available-for-Sale
The Bank assesses at each date of the statement of financial position whether there is objective evidence that a financial asset or a group of financial assets is impaired. In the case of equity investments classified as available for sale, a significant or prolonged decline in the fair value of the security below its cost is objective evidence of impairment resulting in the recognition of an impairment loss. If any such evidence 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 recognized in profit or loss – is removed from equity and recognized in the income statement. Impairment losses recognized 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 recognized in profit or loss, the impairment loss is reversed through the income statement.

3.10. Investments in Associates and Other Equity Investments
Associated entities are those legal entities in which the Bank has a significant influence, and which are neither subsidiaries nor joint investments.

Investment in an associate is initially recognized at cost (purchase price) and on the balance sheet date.

3.11. Cash and Cash Equivalents
For purposes of the cash flow statement, cash, balances with the Central Bank, foreign currency accounts with foreign and domestic banks and short-term deposits up to 30 days held with foreign and domestic banks are all considered to be cash equivalents.

3.12. Borrowings
Borrowings are initially recognized at fair value, net of transaction costs incurred. Borrowings are subsequently stated at amortized cost; any difference between the proceeds (net of transaction costs) and the redemption value is recognized in the income statement over the period of the borrowing using the effective interest method.

3.13. Provisions
Provisions for restructuring costs and damage claims per lawsuits filed are recognized when:
- the Bank has a present legal or contractual obligation as a result of past events;
- it is more likely than not that an outflow of resources will be required to settle the obligation;
- the amount has been reliably estimated.

Where there is a number of similar obligations, the likelihood that an outflow will be required in a settlement is determined by considering the class of obligations as a whole. A provision is recognized even if the likelihood of an outflow with respect to any one item included in the same class of obligations may be remote. Provisions are measured at the present value of the expenditures expected to be required to settle the obligation.

3.14. Employee Benefits
Short-Term Employee Benefits
Short-term benefits include salaries and all contributions on salaries on behalf of employees, paid to the Republic of Srpska Social Security and Pension Funds, and calculated by applying the specific percentage rates stipulated under relevant regulations. Short term employee benefits are recognized as expense in the period in which they were incurred.

3. Summary of Significant Accounting Policies (continued)

Retirement Benefits and Vacation Entitlement
According to the Collective Bargaining Agreement with the Bank's employees, employees are entitled to receive benefits upon retirement. The retirement benefit liability recognized in the balance sheet represents the present value of the defined benefit liabilities as determined by actuarial calculations.

Provisions for retirement benefits and vacation entitlement are disclosed in the balance sheet within "other liabilities."

Retirement benefits provisions are based on actuarial reports and are used only for the purposes they are designated. At the end of each year, an assessment of appropriateness of the amounts of provisions for retirement benefits and vacation entitlements is performed. Additional provision or release of provision is recognized in the income statement, under "other operating income" or "other operating expenses." Benefits falling due more than 12 months after the balance sheet date are discounted to their present value.

3.15. Income Taxes

Current Income Tax
Income tax is calculated in accordance with the tax regulations of the Republic of Srpska. From January 1, 2007, income tax is calculated and paid according to the new Law on Corporate Income Tax and Regulations on Corporate Income Tax Law. Estimated monthly advance payments of income tax are calculated based on prior year tax return.

The final statutory tax basis, upon which a 10% income tax rate is applicable, is determined based on the taxable balance. Income tax presented in the taxable balance is calculated based on the profit for the period, presented in the statutory income statement, together with any adjustments for permanent differences made thereto, as defined by the Law of the Republic of Srpska.

Deferred Income Taxes
Deferred income taxes are calculated on all temporary differences between tax base of assets and liabilities and their carrying amounts in financial statements of the Bank. Deferred tax liabilities are recognized for all taxable temporary differences between tax base of assets and liabilities at balance sheet date and carrying values reported in the financial statements, which will result in taxable amounts for following periods.

Deferred tax assets are calculated for all deductible temporary differences, unused tax assets and unused tax losses up to the amount for which it is likely to be used by future taxable income for realization of deductible temporary differences, unused tax assets and unused tax losses.

Deferred tax assets are recognized where it is probable that future taxable profit will be available against which the temporary differences can be utilized.

Current and deferred taxes are recognized as income and expense and are included in net profit for the period.

3.16. Share Capital and Reserves

Share capital consists of common shares. Share capital is stated at nominal value.

Dividends from shares are recognized as liabilities in the period wherein a decision on dividend distribution is made.

3.17. Revaluation Reserves

Revaluation surpluses are credited to revaluation reserves (Note 3.5). The revaluation surplus included in equity in respect of property and equipment is transferred directly to retained earnings, as a result od revalorisation reserve. However, the increase is recognized in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognized in profit or loss.

When an assets carrying value decreases due to revaluation, the increase is to be recognized as an expense. However, the decrease is to be charged within equity as revaluation surplus up to the amount of the existing revaluation surplus relating to the asset.

3. Summary of Significant Accounting Policies (continued)

3.18. Fair Value

The accompanying financial statements are prepared on a historical cost basis, including adjustments and provisions made to reduce assets to their estimated recoverable amounts.

It is the policy of the Bank to disclose the fair value information of those financial assets and financial liabilities for which published market information is readily and reliably available, and whose fair value is materially different from their recorded amounts. Sufficient market experience, stability and liquidity do not exist for the purchase and sale of loans and other financial assets or liabilities, given that published market information is not readily available. Hence, fair value cannot reliably be determined.

3.19. Related Party Transactions

According to IAS 24 related parties are parties that represent:

- The companies which directly, or indirectly through one or more intermediaries, control or are controlled by, or are under common control with the Bank;
- Associates in which the Bank has an interest that gives it significant influence over the entity and that are neither related parties nor joint investment;
- Private individuals who directly or indirectly have voting power in the Bank that gives them significant influence over the Bank, or any other subject which is expected to influence or be influenced by a related party to the Bank;
- Members of the key management personnel i.e. individuals with authorizations and responsibilities for planning, managing and controlling the Bank's operations, including directors and key management.

When taking into account each possible transaction with a related party, attention is focused on the basis of relationship and not just the legal form (Note 30).

3.20. Custody Operations

Assets and income arising from operating activities, where the Bank performs custody operations, which include holding or keeping the funds for the benefit of individuals, creditors and other institutions are included in Bank's financial statements.

3.21. Segment Reporting

An industry segment is a group of assets and operations engaged in providing products or services that are subject to risks and returns that are different from those of other industry segments.

A geographical segment is engaged in providing products or services within a particular economic environment that are subject to risks and returns different from those of segments operating in other economic environments.

The Bank monitors its performance by industry segments (public, retail, corporate) and by geographical segments (branches) for the purposes of consolidated reporting as a Parent Bank. However, for the purpose of preparing these financial statements, the bank does not disclose in line with IFRS 8, since the Bank does not engage in trade in shares on the domestic market to a sufficient extent and given that the majority shareholder owns dominant interest of 99.79% of the total share capital.

3.22. Equity Investments

Equity investments in related parties are measured at cost.

4. Summary Of Significant Accounting Estimates and Assumptions

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgments are continually evaluated and based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

Impairment Losses on Loans, Deposits with Other Banks and Other Risk-Weighted Assets and Off-Balance Sheet Items

The Bank reviews its loan portfolio and other risk-weighted assets and off-balance sheet items to assess impairment at least on a quarterly basis. In determining whether an impairment loss should be recorded in the income statement, the Bank makes judgments as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans and guarantees before the decrease can be identified with an individual exposure in that portfolio. The methodology and assumptions used for estimating impairment provision in accordance with BARS regulations is disclosed in Note 3.9.

Retirement benefits

Expenses for long-term provisions related to the future outflows regarding retirement of employees are assessed based on the actuarial calculation done in accordance with IAS 19. For the purposes of the assessment, the Bank engages a certified actuary, who performs the calculation based on the data from HR department of the Bank based on the estimated time of employees' retirement. The present value of the future liabilities is calculated by applying a discount rate. These provisions are only used to settle expenses that they have originally been formed for. At the end of each year the Bank assesses these provisions. If the amount recorded is higher / lower than estimated amount, the difference is released through profit or loss.

The certified actuary has performed a new actuarial calculation during 2011 in accordance with IAS 19. Following the new calculation the Bank has decreased previously recognized provisions by crediting the income statement. An assessment of short-term provisions for unused annual vacations is done in based on the number of days of unused annual vacations as of balance sheet date and the average monthly employee's gross salary.

Litigations

The Bank's management assesses the amount of provisions for outflows based on the litigations. The assessment is based on the estimated probability of future cash outflows, arising from the past contractual or legal obligation (Note 29).

Income taxes

The Bank is subject to income taxes in the Republic of Srpska and Bosnia and Herzegovina. The Bank recognizes liabilities for anticipated tax audit issues based on estimates of whether additional taxes will be due. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax provisions.

Deferred tax assets disclosed at December 31, 2011 are based on assumptions on profitability for the period of the five ensuing years. In the case of a change in the assumptions on profitability, adjustment of disclosed tax assets can occur.

Losses on Impairment of Loans and Advances

The Bank reviews its loan portfolios at least quarterly in order to assess impairment. When establishing whether impairment loss is to be stated in the income statement, the Bank assesses the existence of objective evidence of measurable decrease in the estimated future cash flows from the loan portfolio before it is possible to determine decrease in individual loans of the portfolio. Objective evidence of portfolio impairment could include perceptible data suggesting negative changes in the financial standing of the Bank's borrowing customer, as well as changes in the national or local economic circumstances that are associated with the default receivables.

4. Summary Of Significant Accounting Estimates and Assumptions (continued)

When determining future cash flows, the Bank's management uses estimates based on previous experiences of impairment losses on an asset with similar credit risk characteristics and objective impairment evidence similar to that of the portfolio. Methodology and assumptions used to estimate both amounts of the future cash flows and the time of their occurrence are regularly reviewed in order to minimize all the differences between estimated and actual losses.

Impairment of Assets Available-for-Sale

The Bank determines that the equity investments available-for-sale are impaired when there have been a significant and prolonged decrease in their fair value below their cost. Determining a significant and prolonged decrease demands assessment. Among other factors, the Bank assesses normal fluctuations in the prices of shares.

In addition, decrease in fair value may be appropriate when there is evidence of the deterioration of the sound financial standing of the investor, deterioration of the success of the industry or sector, changes in technology and operating and financing cash flows.

If each decrease in fair value below cost were to be considered significant and prolonged, the Bank would have incurred additional loss in the amount of BAM 94 thousand in the financial statements for the year 2011, which would represent the transfer of the total fair value reserves to the income statement.

Fair Value of Property, Equipment and Investment Property

Fair value of property, equipment and investment property is assessed based on the market value of similar property based at similar locations by certified appraisers on a regular basis. Fair value is determined by means of capitalization valuation method (income approach) that takes into account real or realizable annual income from the property under valuation, which is then compared to the value of investment. The real annual income is then decreased by the costs of maintenance, depreciation, taxes and risk of rent payment default or failure to lease property. Factors applied in the assessment are specific for the market of Bosnia and Herzegovina. The net book value of property, equipment and investment property as of December 31, 2011 represents their estimated fair value (Note 17).

5. Financial Instruments

a) Financial Risk Management

Risk management strategy of the Bank is to maintain stable performance in the future. The Bank applies policies and strategies of credit and market risk. The Bank controls a variety of risks with respect to the data structure, methodology adopted, reporting and limits arising in the decision making process. The Bank has an internal risk management model. The most important tools and methods used in the model for internal risk management are: internal credit rating system (for Corporate, Retail and Banks), collaterals, internal indicators in respect of provision / bad debts, etc. The use of risk management has a large impact on asset quality, structural liquidity, efficiency ratios and early warnings, and it reduces exposure to all types of risks.

The Bank is exposed to the following major types of risks: credit risk, market risk, liquidity risk, operational risk.

Credit Risk Management

The Bank is exposed to credit risk which is the risk that a counterparty will be unable to pay amounts in full when due. The Bank structures the levels of credit risk it undertakes by identifying possible level of credit loss, i.e. general credit risk and potential credit loss.

Assessment of impairment losses is performed for both individual borrowers and groups of related-party borrowers. Such risks are monitored on a continuous basis in accordance with the internal programs and policies, as well as BARS regulations.

5. Financial Instruments (continued)

Exposure to credit risk is managed through regular analysis of the ability of borrowers and potential borrowers to meet interest and capital repayment obligations and by changing lending limits where appropriate. This is done in accordance with set procedures for credit approval, additional lending, investment activities, and assessment of potential out-of-balance liabilities. Exposure to credit risk is also managed in part by reduction of all kinds of possible risk sources related to quality, concentration, guarantees of payment (all loans are insured with collaterals and corporate and personal guarantees), maturity and currency.

On October 1, 2009, the Bank has established a new department – Department for credit risk management, dedicated to risk monitoring for Corporate and Retail clients, as defined by the Hypo Alpe Adria Group ("HGAA" or the "Group") policies. By introducing new policies and establishing a new department, the Bank managed to put in place clearer and more strict criteria for new financing granted. The Bank has also increased the level of awareness of its employees related to continuous monitoring of clients, early risk identification and steps taken to address the risk. In order to increase the quality of credit risk assessment, responsibility for credit risk monitoring was delegated to an individual level (not only the credit committee level).

The Bank approves loans in accordance with a defined process for loan approval, and based on the creditworthiness of clients and security instruments.

Creditworthiness of a borrower must be presented in the document "Loan proposal" based on which lending decisions are made. Loan proposal has to include the assessment of Market department and Risk management department.

Loan decisions are made (and the competences determined) based on total liabilities/limits defined at the Group level.

There are eight levels of authority for approving the placements of which the highest is Supervisory Board of the Parent Company (HBInt). Department for credit risk management has the right to vote in each committee.

In order to ensure business activities, and on the basis of assessed risk of potential losses, the Bank performs the calculation of provisions, based on risk exposure arising from loans and off-balance sheet receivables. The level of provision is determined by the degree of placement risk.

Corporate Customer Ranking System

Ranking system in the Bank (as in the whole Group) must be presented in accordance with the rating system of the Group (five rating classes and five levels within the class). All internal ratings count one-year probability of default (PD) based on a weighted average of the following risk parameters:

- unconsolidated financial indicators (hard facts)
- sector and management (soft facts).

In addition, other factors such as the regularity of settlement of liabilities, assessment of creditworthiness affect the final customer rating.

Customer rating is calculated for each loan request. After the initial calculation, the rating of the customer is updated based on annual customer monitoring at least once a year.

The Bank's maximum exposure to credit risk was as follows:

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Cash and balances held with the Central Bank (CBBH)	245,434	169,699
Deposits with banks	16,337	28,829
Loans and advances to customers, net	1,096,453	1,243,920
Securities available-for-sale	15,454	1,080
Other financial assets	5,574	4,908
	1,379,252	1,448,436

5. Financial Instruments (continued)

Loans and advances to customers (net) and deposits with banks are presented in the following tables:

	In thousands of BAM					
	Banks	Financial Institutions	Corporate Clients	Retail Clients	Government	Total
December 31, 2011						
No past-due	16,339	5,131	321,971	393,029	117,961	854,431
1 to 90 days past-due	-	-	93,272	84,607	-	177,879
Over 90 days past-due	-	-	48,043	106,249	-	154,292
Total	16,339	5,131	463,286	583,885	117,961	1,186,602
SRP/SRPci	-	-	(27,801)	(39,009)	-	(66,810)
PRPLL	(2)	(106)	(2,544)	(3,946)	(403)	(7,001)
Less: Allowance for impairment	(2)	(106)	(30,345)	(42,955)	(403)	(73,811)
Net	16,337	5,025	432,941	540,930	117,558	1,112,791

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	Banks	Financial Institutions	Corporate Clients	Retail Clients	Government	Total
December 31, 2010						
No past-due	28,831	3,859	303,472	445,296	80,633	862,091
1 to 90 days past-due	-	-	114,271	91,268	-	205,539
Over 90 days past-due	-	-	314,654	61,354	-	376,008
Total	28,831	3,859	732,397	597,918	80,633	1,443,638
SRP	(2)	-	(122,975)	(12,200)	-	(135,177)
PRPLL	-	(111)	(10,754)	(24,767)	(80)	(35,712)
Less: Allowance for impairment	(2)	(111)	(133,729)	(36,967)	(80)	(170,889)
Net	28,829	3,748	598,668	560,951	80,553	1,272,749

5. Financial Instruments (continued)

Exposure to credit risk from loans and advances to customers, net and deposits with banks per rating was as follows:

	In thousands of BAM							
	Banks		Corporate Clients		Retail Clients		Total	
	Gross	Risk provision	Gross	Risk provision	Gross	Risk provision	Gross	Risk provision
December 31, 2011								
No rating	6,637	-	14,573	(297)	9	-	21,219	(297)
1A-1E	1,182	-	-	-	-	-	1,182	-
2A-2E	8,370	(2)	76,175	(1,091)	25,992	(643)	110,537	(1,736)
3A-3E	-	-	84,272	(879)	293,555	(7,256)	377,827	(8,135)
4A-4E	150	-	335,454	(2,754)	205,828	(17,753)	541,432	(20,507)
5A-5E	-	-	75,895	(25,824)	58,510	(17,312)	134,404	(43,136)
Total	**16,339**	**(2)**	**586,369**	**(30,845)**	**583,894**	**(42,964)**	**1,186,601**	**(73,810)**
Total (net)		**16,337**		**555,524**		**540,930**		**1,112,791**

	In thousands of BAM							
	Banks		Corporate Clients		Retail Clients		Ukupno	
	Gross	Risk provision	Gross	Risk provision	Gross	Risk provision	Gross	Risk provision
December 31, 2010								
No rating	84	-	22,078	(19,381)	397	(324)	22,559	(19,705)
1A-1E	953	-	-	-	-	-	953	-
2A-2E	27,188	-	13,629	(101)	7	-	40,824	(101)
3A-3E	374	-	233,079	(1,391)	538,875	(18,917)	772,328	(20,308)
4A-4E	232	(2)	142,528	(1,655)	1,580	(56)	144,340	(1,713)
5A-5E	-	-	405,565	(111,384)	57,069	(17,678)	462,634	(129,062)
Total	**28,831**	**(2)**	**816,879**	**(133,912)**	**597,928**	**(36,975)**	**1,443,638**	**(170,889)**
Total (net)		**28,829**		**682,967**		**560,953**		**1,272,749**

Impairment Losses and Provisioning Policy

Impaired loans and securities are those loans and securities for which the Bank determines that it is not likely it will be able to collect all principal and accrued interest under the provisions of the loan agreement / securities. Individually impaired assets are those assets that are individually assessed to have been impaired and have estimated losses recognized.

The Bank assesses impairment of receivables for incurred losses in the credit portfolio.

Classification of receivables is based on an analysis of delays in settlement of obligations and indicators of return. In the case of individual loan impairment, future estimated cash flows are discounted in accordance with the requirements of IAS 39, to arrive at an appropriate amount of provision.

5. Financial Instruments (continued)

Write-Off Policy

Write-off policy is managed very carefully based on prior analysis of pricing options, where the Bank has estimated that the collection of receivables is not possible. Write-off proposal is given by the department in charge of the client at any time by the assessment that some receivables are uncollectible. Final write-off of receivables is the responsibility of the Management Board and Supervisory Board, depending on the write-off amount.

The following table presents maximum credit risk exposure for balance sheet components:

	In thousands of BAM				
	Total Carrying Valuest	Without Impairment	Individual Impairment (SRP/SRPci)	Collective Impairment (PRPLL)	Total Net Carrying Value
December 31, 2011					
Cash and balances with the Central Bank (CBBH)	245,434	245,434	-	-	245,434
Deposits with banks	16,339	16,339	-	(2)	16,337
Loans and advances to customers	1,170,262	278,329	(66,810)	(6,999)	1,096,453
Securities available-for-sale	15,454	15,454	-	-	15,454
Other financial assets	6,468	4,899	(847)	(47)	5,574
	1,453,957	560,455	(67,657)	(7,048)	1,379,252
December 31, 2010					
Cash and balances with the Central Bank (CBBH)	169,699	169,699	-	-	169,699
Deposits with banks	28,831	27,269	(2)	-	28,829
Loans and advances to customers	1,414,807	363,791	(135,175)	(35,712)	1,243,920
Securities available-for-sale	1,080	1,080	-	-	1,080
Other financial assets	5,773	4,125	(846)	(20)	4,907
	1,620,190	565,964	(136,023)	(35,732)	1,448,435

Loans and advances to customers, net of impairment provisions were as follows:

	In thousands of BAM		
	Loans to customers, gross	Impairment	Loans to customers, net
December 31, 2011			
Portfolio risk provision	955,614	(6,999)	948,615
Specific risk provision	214,648	(66,810)	147,838
	1,170,262	(73,809)	1,096,453
December 31, 2010			
Portfolio risk provision	1,044,471	(35,712)	1,008,759
Specific risk provision	370,336	(135,175)	235,161
	1,414,807	(170,887)	1,243,920

5. Financial Instruments (continued)

The breakdown of the gross amount of individually impaired loans and advances to customers and deposits with banks, along with the fair value of related collateral held by the Bank as security was as follows:

	In thousands of BAM				
	Banks	Corporate Clients	Retail Clients	Government	Total
December 31, 2011					
Gross amount	**-**	**87,167**	**127,481**	**-**	**214,648**
Individually impaired loans	-	(27,801)	(39,009)	-	(66,810)
Fair value of collaterals	-	60,241	70,815	-	131,056
December 31, 2010					
Gross amount	**1,564**	**335,501**	**34,838**	**-**	**371,903**
Individually impaired loans	(2)	(122,975)	(12,198)	-	(135,175)
Fair value of collaterals	-	204,169	21,292	-	225,461

Collaterals

In accordance with the standard principles of crediting business, the Bank demands collaterals for the purpose of securitizing placements against the risk of inability or unreadiness of the counterparty to settle the contractual liabilities.

Collaterals usually comprise one or a combination of more of the following security instruments:

- cash deposits in BAM or foreign currency;
- guarantees issued by Government, Government funds or banks, first class;
- guarantees issued by the parent company, other legal entities and individuals;
- letters of comfort issued by the parent company;
- mortgage over property;
- pledge of movable property;
- own blank promissory notes;
- pledge of shares and equity shares;
- a pledge of other securities (bonds) or precious metals;
- assignment of receivables (with or without notice);
- takeover of rights from insurance policy.

The Bank reserves the right to request any other type of instrument (or variations of the instruments stated above) that it considers necessary.

Assessment of fair value of impaired assets is based on the value of the security at the time of loan approval, and is updated periodically in accordance with the relevant credit Bank policy.

5. Financial Instruments (continued)

Credit Exposure and Collaterals

	In thousands of BAM					
	Retail Clients		Corporate Clients		Total	
	Maximum Credit Risk Exposure	Fair Value of Collaterals	Maximum Credit Risk Exposure	Fair Value of Collaterals	Maximum Credit Risk Exposure	Fair Value of Collaterals
December 31, 2011 Credit exposure, net	540,930	232,232	555,523	364,898	1,096,453	597,130
December 31, 2010 Credit exposure, net	560,845	236,035	683,075	525,892	1,243,920	761,927

The analysis of the Bank's financial assets by industrial sectors at gross and net principle (less provision) is presented into the following table:

	In thousands of BAM			
	December 31, 2011		December 31, 2010	
		%		%
Retail customers	584,621	40.14%	598,251	36.91%
Trade	138,837	9.53%	286,660	17.69%
Mining and industry	166,329	11.42%	212,453	13.11%
Services, tourism and catering business	23,161	1.59%	183,255	11.31%
Transport and communications	7,921	0.54%	82,973	5.12%
Real estate	50,246	3.45%	69,052	4.26%
Agriculture, forestry and fishing	12,919	0.89%	50,351	3.11%
Construction industry	34,048	2.34%	49,259	3.04%
Financial institutions	247,085	17.14%	31,480	1.94%
Energy production	16,045	1.10%	19,783	1.22%
Administration and other public services	135,333	9.29%	6,135	0.38%
Other	37,412	2.57%	31,069	1.92%
Less: Allowance for impairment	(74,705)		(172,285)	
	1,379,252		1,448,436	

Non-Performing Placements

Non-performing placements are those placements that are over 90 days past-due (materially significant past-due means that the liabilities exceed 2.5% of the total exposure and that the delay from entering the materially significant past-due status is longer than 90 days) or the placements where there are obvious problems in business operations. According to classification, these are the placements that belong to categories C, D and E or assets with specific provisions in line with IAS ("NPL Placements"). Assets in B category are additionally monitored but are not considered NPL placements. Managing problematic assets is centralized in Bosnia and Herzegovina, and, since April 2011, and performed by three departments: Rehabilitation Department in charge of corporate and public sectors, Collection Department in charge of SME and retail sector and specialized Local Task Force Rehabilitation Department (LTFR) in charge of monitoring project financing and tourism.

5. Financial Instruments (continued)

Rehabilitation Department is comprised of three sub-departments: Restructuring Sub-Department for monitoring active clients that could recover through debt restructuring and repay the placements to the Bank, Forced Collection Sub-Department in charge of clients subject to forced collection procedure and Monitoring and Provisioning Sub-Department in charge of credit risk monitoring.

Upon identification of a client as a NPL client, the Rehabilitation Department assumes competence and responsibility for the whole Group's clients with the Bank and HETI as well as for defining collection strategy at the Group level.

The Rehabilitation Department is competent for client processing and monitoring as well as for suggesting manners of resolving and possibilities for collecting the Bank's receivables, calculation of credit risk per client in line with the local regulations and IFRS standards, and collection of receivables using all available legal means.

Restructured placement is a placement that is refinanced, reprogrammed or otherwise converted, or placement in which, due to the client's changed conditions and repayment capabilities, or his inability to make repayment in line with initially agreed repayment plan; or because of the revised (lower) current market rate, previously agreed deadlines (period or repayment plan) and/or other conditions subsequently changed so that the Bank can improve the client's debt servicing.

Restructured problematic assets are assets when the Bank grants one or more rebates and concessions to the debtor with financial difficulties. Concessions and rebates include:

- taking other assets, that is debtor's property as total or partial collection of Bank's receivables,
- extending the deadline for principal receivable and/or interest,
- reduction of receivables interest rate,
- reduction of debt, principal receivable matured and /or interest,
- other similar concessions.

Rehabilitation Department

In view of unfavorable circumstances in the economic environment that continued well into the year 2011 wherein it operates, the Bank directed its business policy toward approving concessions to clients by means of wide-range possibilities for restructuring their comprehensive debts. When approving rescheduled loans due to deterioration of corporate clients' business operations or retail clients' creditworthiness, particular attention was paid to the prior business cooperation and causes that led to the problems in business operations, as well as assessing the certainty of economic recovery which should occur in the future.

In the course of 2011, the Bank approved additional concessions and rebates to the clients that invested significant efforts in overcoming their insolvency and excessive indebtedness and, together with the Bank, sought solutions to resolve the problems such as:

- approval of new grace periods together with significant reductions of interest rates within defined periods and
- approval of discounts to the clients who found new creditors or investors for assignment of the Bank's loans, which suggested more promising prospects of their recovery.

The Bank's restructuring strategy proved wise, which is evident in the stated amount of collected interest on restructured loans in 2011(suspended interest) and decrease in the total receivables per clients with largest debts.

Collection Department

Collection Department operates through the following sub-departments:

- Call Center with three sub-department (Early Collection – in charge of collection of matured liabilities 10 to 30 days past-due, Prevention – in charge of collection of matured liabilities 31 to 90 days past-due and Loss Recovery – in charge of collection of matured liabilities over 90 days past-due). All three sub-departments perform collection by continuous telephoning to all loan participants, arranging repayment schedules and recording these in a special computer program application adjusted for this purpose. Call agents are prohibited from harassing, insulting and humiliating clients in the process of collection. Text messages are also used for the purpose of collection from clients under the competence of Prevention and Loss Recovery sub-departments:

5. Financial Instruments (continued)

- Administration sub-unit performs back office operations (past-due notice sending, text message notice sending, loan agreement terminating), loan restructuring and rescheduling, skip tracing (collecting and updating information on clients), anti-fraud operations, promissory note and bill of exchange foreclosures (blocking legal entities' transaction accounts and collecting due payments from them), activating administrative suspension of earnings and collaboration with external collection agencies.
- Legal sub-unit is in charge of preparation of documentation required for filing and participating in lawsuits up to the final realization as well as of the Bank representation in court of law.
- Remarket sub-unit is in charge of sales of "movable" assets.

Restructured and refinanced loans as of December 31, 2011 and 2010 can be summarized as follows:

	In thousands of BAM	
	Number of restructured loans	Amount
December 31, 2011		
Corporate clients	37	159,040
Retail clients and entrepreneurs	199	3,374
Total	**236**	**162,414**
December 31, 2010		
Corporate clients	60	122,987
Retail clients and entrepreneurs	30	1,083
Total	**90**	**124,070**

Off-Balance Sheet Items

Loan Commitments

Maturity dates of the contractual amounts of the Bank's off-balance sheet financial liabilities that it has committed to extend as loans and advances to customers are summarized in the table below:

	In thousands of BAM			
	Up to 1 year	From 1 to 5 years	Over 5 years	Total
At December 31, 2011				
Loan commitments	43,276	4,762	32,671	80,709
At December 31, 2010				
Loan commitments	43,864	10,808	19,946	74,618

Other Financial Liabilities

Other financial liabilities are included in the table below, based on the earliest contractual maturity date:

	In thousands of BAM			
	Up to 1 year	From 1 to 5 years	Over 5 years	Total
At December 31, 2011				
Payment guarantees, performance bonds and letters of credit	23,865	8,616	2,220	34,701
At December 31, 2010				
Payment guarantees, performance bonds and letters of credit	24,399	11,537	2,454	38,390

5. Financial Instruments (continued)

b) Market Risk

Market risks consist of potential losses due to a change in market prices. The Bank classifies market price risks according to the risk factors in changes to interest rates, credit spread, currency, volatility and share price risks, as well as risks from alternative investments.

Market price risks may result from securities (and products similar to securities), money and foreign currency products, derivatives, currency exchange and results hedging, assets similar to equity or from management of assets and liabilities

Besides market risks, market liquidity risks may also be incurred if, in the event of low market demand, the Bank is unable to liquidate trading positions during liquidity shortfalls (or due to risk-based offsetting requirements) in the short term. For existing positions, these are taken into account as part of the risk limitations for market risks.

General Requirements

The Bank develops its market risk strategy on the basis of strategic discussions between the treasury units in charge and Risk controlling. Decisions on combined business and risk strategies are only made in the Asset-Liability Committee (ALCO).

As part of the daily reporting procedure, the Management board receives value-at-risk and performance figures for trading transactions on a daily basis and figures on banking book investments and market risk steering on a weekly basis. There is also a daily report to the Management board in which the key risk and performance figures of the subsidiaries are communicated. In these, the value-at-risk at the subsidiary level is compared to the defined limits. Limit breaches initiate defined escalation processes up to Management board level.

The subsidiaries of HGAA calculate risk as per HGAA specifications for the respective portfolios. The results are presented to the Management board as part of ongoing reporting for HGAA. This is also applicable for the Bank, as a subsidiary of HGAA.

Risk Measurement

The Bank calculates its market risk as part of daily monitoring with value-at-risk methods on the basis of a one-day holding period, with a confidence level of 99% in full accordance to group standards. The main instrument used in this process is the Monte Carlo simulation with an exponentially weighted history of 250 days. For the purpose of determining risk capital requirements for the risk bearing capacity calculation, values are scaled to the uniform confidence level of 99.895%, assuming liquidation over a time period of 126 days.

The models calculate potential losses taking into account historic market fluctuations (volatilities) and market context (correlations). The reliability of market risk measurement methods is regularly examined with regard to the quality of individual risk methods. As part of back testing, the risk forecast is compared with the result (profit or loss). In accordance with the Basel 'traffic light' approach, the forecast quality of the risk model is appropriate.

While the VaR that is determined for monitoring requirements is used to forecast potential losses under normal market conditions, future-oriented analyses using extreme assumptions are also carried out. Market positions are subjected to exceptional market price changes, crisis situations and worst case scenarios as part of so-called "stress tests", and analyzed for hazardous risk potentials using the simulated results. The stress scenarios are monitored for appropriateness and adjusted if required. The Bank does not currently use its own internal risk models for regulatory purposes. Instead, it uses the standard Group method.

The interest rate change risk in the investment book is determined as a present value risk, as are all market risks at the Bank. The risk of interest rate changes in the investment book is for the most part integrated into ongoing risk monitoring of market risk controlling as per value-at-risk. Contractual cancellation rights are modeled as an option, and flow into the risk calculation. All stochastic positions are accounted for in accordance with internal models. As per Basel II specifications, a 200 basis point interest rate shock scenario is calculated for the interest rate change risk in the investment book. The cash value changes calculated in relation to the regulatory equity are well below under the so-called "outlier criterion". In addition, a large number of possibly occurring market fluctuations can be calculated and illustrated through a calculation of standard, forward, historic and extreme scenarios.

5. Financial Instruments (continued)

Risk Mitigation

In accordance with the new risk strategy from the Group, which was adopted in August 2010, a limit of 10% of risk capital has been set for market risk. The amount of risk capital set represents the maximum loss that may be incurred for absorbing market risk. Market risk capital is distributed over individual market risk factors (interest rate, currency, shares, credit spread, volatility and alternative investments) by setting risk factor limits. Risk factor limits are also further defined and differentiated through defined partial portfolios. In addition a limit system also provides support through defined warning levels, which show negative developments early on.

Risk Control and Monitoring

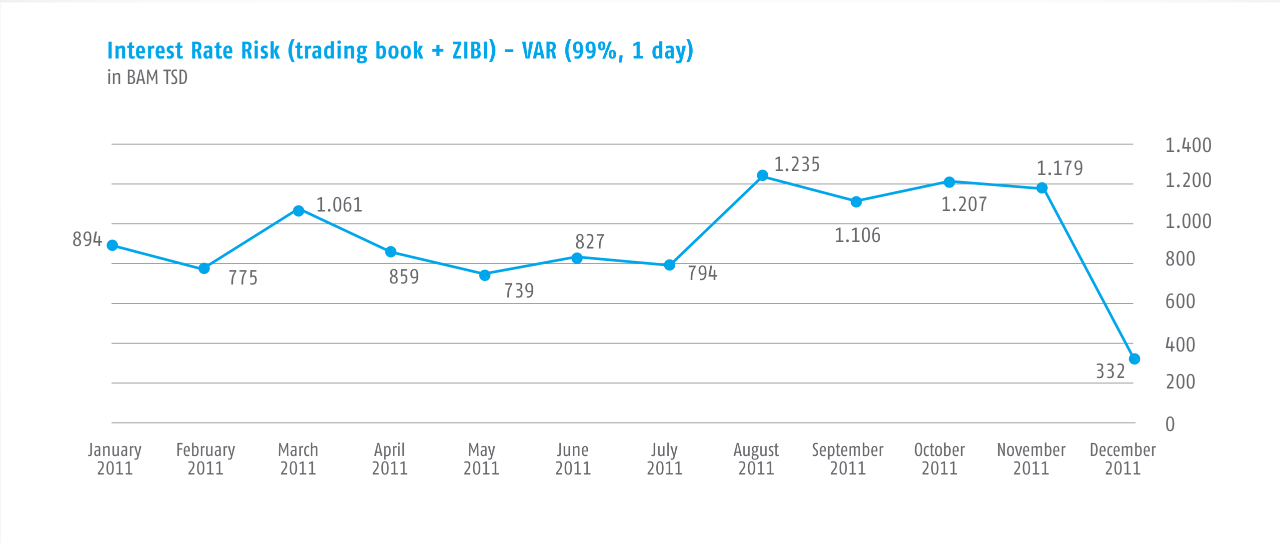
All market risks are centrally monitored by Risk Control, which is independent of all trading activities. In addition to regulatory requirements, this unit also ensures risk transparency and regular reporting to the Management Board member responsible for this area. The Management Board also receives a separate monthly report on the actual market risk situation as well as on back testing and stress test results with a commentary on potentially significant developments.

The control of interest rate risk is carried out on an institutionalized basis in compliance with the regulatory requirements related to interest rate risk statistics. The Asset Liability Committee, which consists of the Management Board as well as key staff in Treasury, Risk Control and Financial Control, meets on a regular basis to analyze and decide on measures related to balance sheet structure and liquidity control.

Market Risk Overview

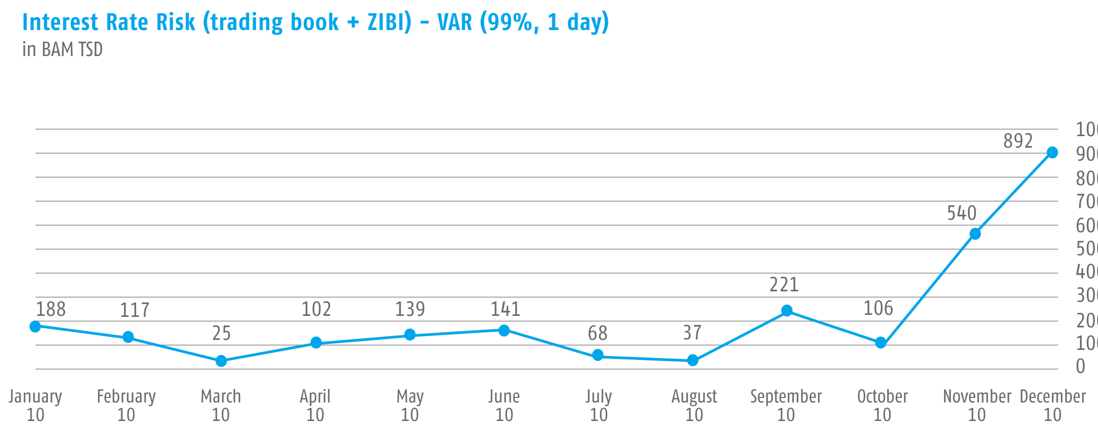
The table shows the progression of interest rate risk (including the interest rate risk of the trading book) for the Bank in 2011. The fixed-interest period statement for the Bank contains all interest rate relevant on and off balance sheet items with their next interest rate fixing date. The stochastic cash flows are illustrated with uniform standards given by the Group and with local models for country-specific transactions. The graph shows the interest rate change risk for the Bank at overall Bank level (trading book and banking book).

Interest Rate Risk (Securities Trading Book + Banking Book) – 2011



5. Financial Instruments (continued)

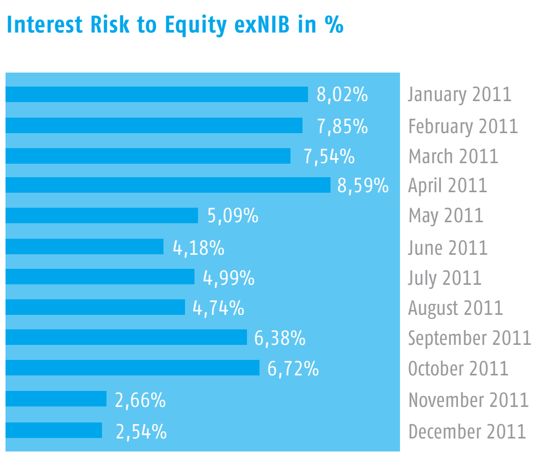
Interest Rate Risk (Securities Trading Book + Banking Book) – 2010

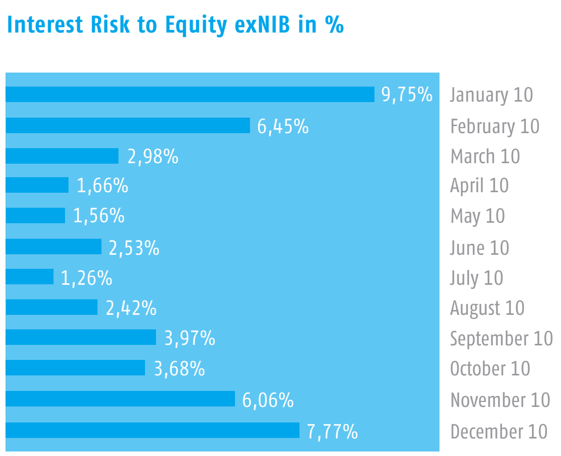


The methodology of the interest risk calculation is oriented to the specifications of the Austrian National Bank (Oesterreichische Nationalbank - OeNB) regarding the calculation of interest risk statistics.

Initially, interest risks per defined currency are determined on the basis of the Bank's fixed interest period statement; a second step calculates the risk equity ratio as a percentage of capital resources.

Interest Risk to Equity Ratio in %

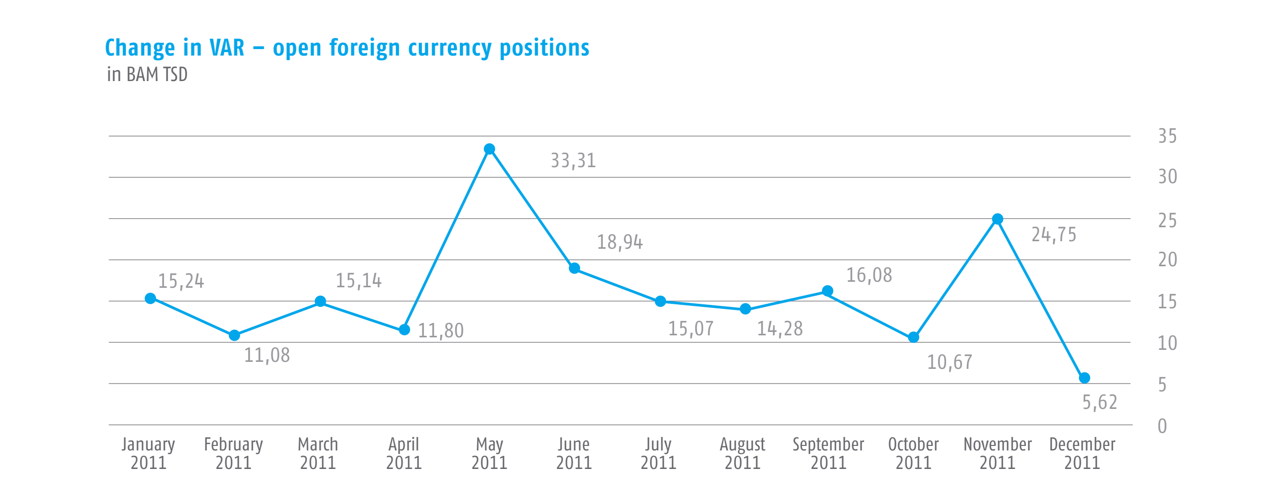




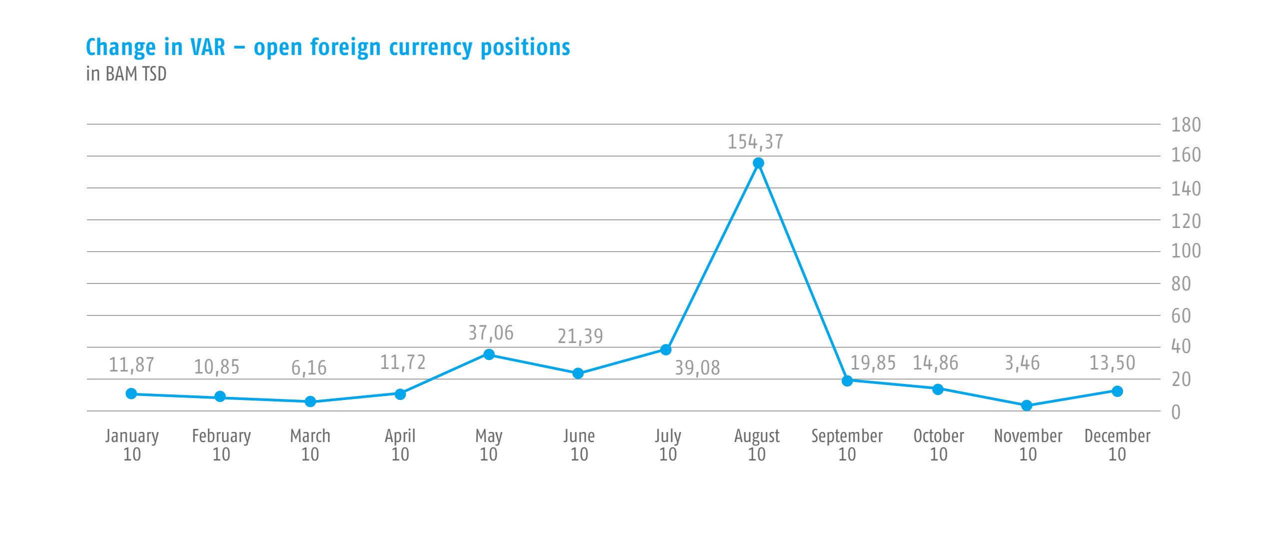
5. Financial Instruments (continued)

The data basis for determining the value-at-risk for open foreign currency positions at the Bank level is based on the figures of the OeNB report and contains operational business activities. The value-at-risk for this foreign currency risk was approximately BAM 5.62 thousand (EUR 2.87 thousand) as of December 31, 2011, at a confidence interval of 99%.

Change in VAR – open foreign currency positions – 2011



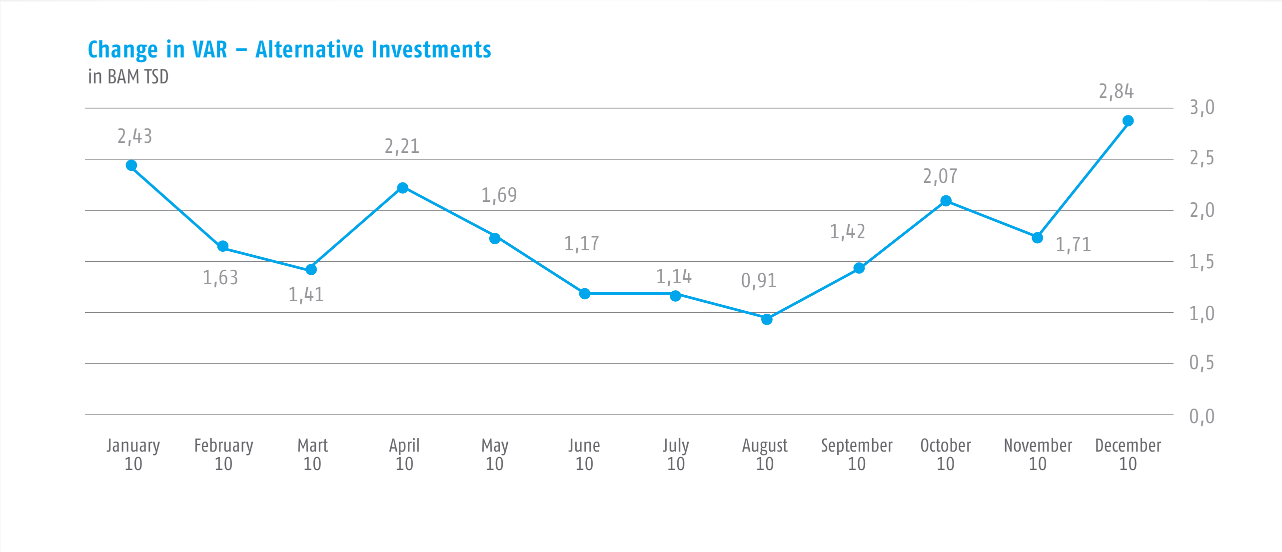
Change in VAR – open foreign currency positions – 2010



The Bank did not have alternative investments in 2011.

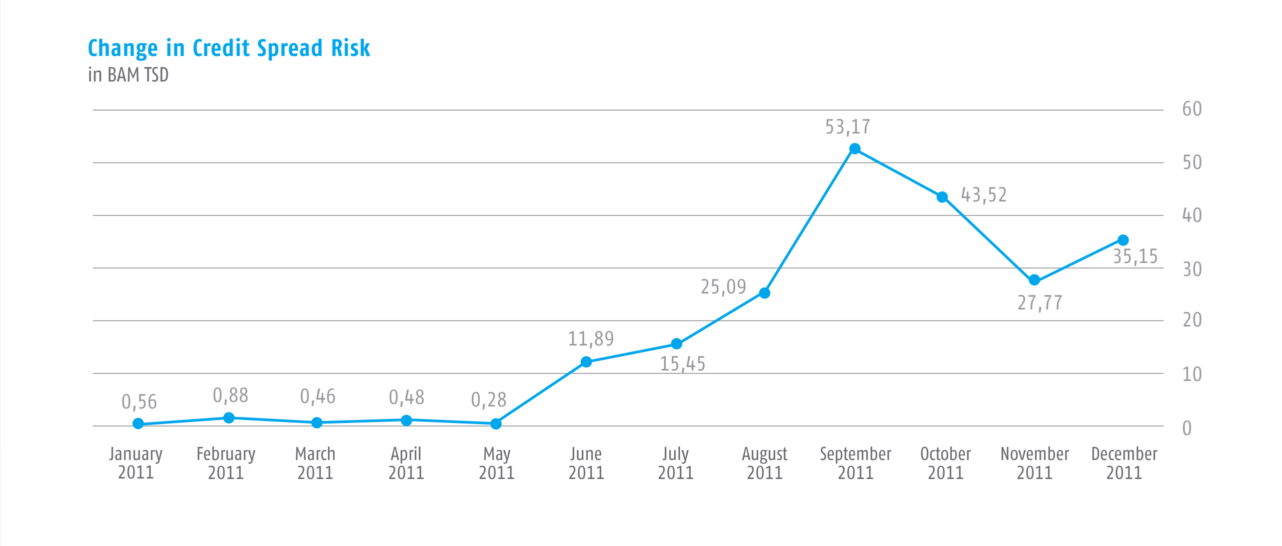
5. Financial Instruments (continued)

Change in VAR – Alternative Investments – 2010



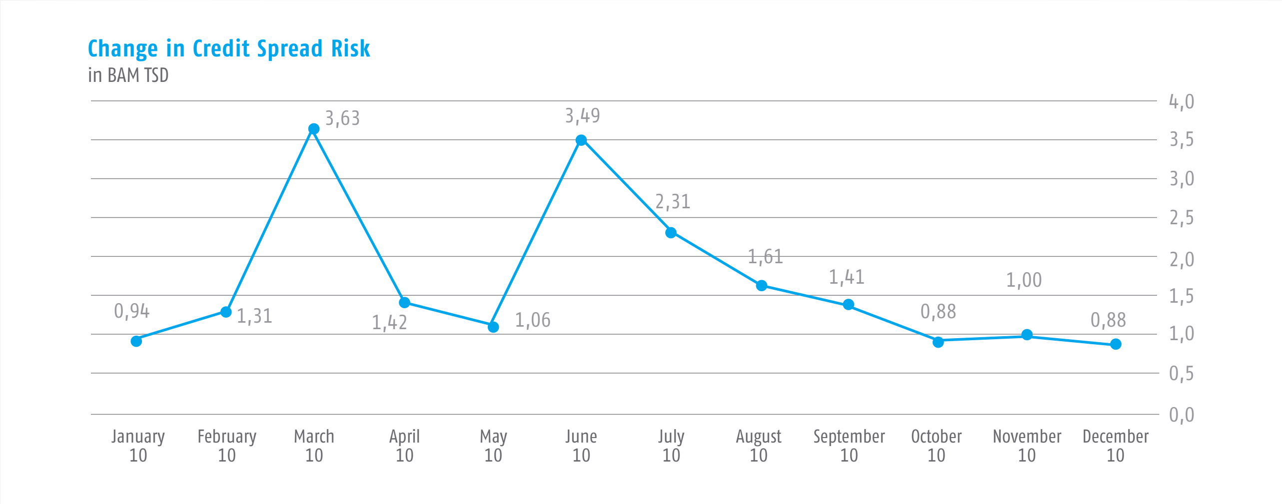
The credit spread risk for the Bank at year-end 2011 amounted to BAM 35.15 thousand (EUR 17.97 thousand), with a 1-day value-at-risk and a confidence level of 99%.

Change in Credit Spread Risk – 2011



5. Financial Instruments (continued)

Change in Credit Spread Risk – 2010



c) Foreign Currency Risk

Foreign currency risk is Bank's exposure to possible impact of change in foreign currency exchange rate and danger that unfavorable changes may result in loss denominated in BAM (domestic currency). The level of risk is a function of height and length of the Bank's exposure to possible changes of foreign exchange rates, and depends on the amount of Bank borrowing in foreign currency and the degree of alignment of assets and liabilities of the Bank's balance sheet and off-balance sheet, for example the degree of compliance of its currency flows.

Foreign currency risk exposure arises from credit, deposit, investment and trading activities. It is controlled daily in accordance with legislation and the internally set limits for each currency and for the assets and liabilities denominated in foreign currencies. During the year opened currency positions were held within the limits prescribed by the Decisions of BARS and the internal limits set according to the Group methodology. Foreign currency adjustment of financial assets and liabilities are reflected through purchase and sales of all foreign currencies and by including foreign currency clause into agreements on deposits and monitoring approval of loans with foreign currency contractual clause. Foreign currency risk activities and responsibilities are defined in the Bank's Foreign Currency Risk Program.

5. Financial Instruments (continued)

The Bank had the following foreign currency assets and liabilities:

					In thousands of BAM		
	EUR	USD	CHF	Other currencies	Total foreign currencies	Total BAM	Total
As of December 31, 2011							
ASSETS							
Cash and balances with the Central Bank	7,174	405	841	1,243	9,663	235,771	245,434
Deposits with banks	6,283	6,103	2,572	1,379	16,337	-	16,337
Loans and advances to customers	740,213	25	192,265	-	932,503	163,950	1,096,453
Securities available-for-sale	24	353	-	-	377	15,077	15,454
Other financial assets	1,013	75	-	-	1,088	4,486	5,574
Total assets	**754,707**	**6,961**	**195,678**	**2,622**	**959,968**	**419,284**	**1,379,252**
LIABILITIES							
Deposits held by banks and financial institutions	211,166	8	187,615	-	398,789	42,132	440,921
Customers' deposits	330,434	6,962	7,585	1,690	346,671	196,649	543,320
Borrowings	146,261	-	-	-	146,261	-	146,261
Subordinated liabilities	35,470	-	-	-	35,470	-	35,470
Other financial liabilities	13,181	2	7,262	-	20,445	18,536	38,981
Total liabilities	**736,512**	**6,972**	**202,462**	**1,690**	**947,636**	**257,317**	**1,204,953**
Net balance sheet foreign currency position	**18,195**	**(11)**	**(6,784)**	**932**	**12,332**	**161,967**	**174,299**

					In thousands of BAM		
	EUR	USD	CHF	Other Currencies	Total Foreign Currency Balance	Total BAM Balance	Total
As of December 31, 2010							
ASSETS							
Cash and balances with the Central Bank	8,147	583	1,254	1,092	11,076	158,623	169,699
Deposits with banks	21,414	5,378	931	1,106	28,829	-	28,829
Loans and advances to customers	770,142	-	323,367	-	1,093,509	150,411	1,243,920
Securities available-for-sale	24	344	-	-	368	712	1,080
Other financial assets	786	59	-	3	848	4,060	4,908
Total assets	800,513	6,364	325,552	2,201	1,134,630	313,806	1,448,436
LIABILITIES							
Deposits held by banks and financial institutions	230,691	9	302,133	-	532,833	28,131	560,964
Customers' deposits	328,003	6,066	4,030	1,251	339,350	182,190	521,540
Borrowings	150,911	-	-	-	150,911	-	150,911
Subordinated liabilities	35,470	-	-	-	35,470	-	35,470
Other financial liabilities	5,830	8	2,177	-	8,015	18,912	26,927
Total liabilities	**750,905**	**6,083**	**308,340**	**1,251**	**1,066,579**	**229,233**	**1,295,812**
Net balance sheet foreign currency position	**49,608**	**281**	**17,212**	**950**	**68,051**	**84,573**	**152,624**

5. Financial Instruments (continued)

d) Interest Rate Risk

The Bank's operations are influenced by changes in interest rates to the extent to which interest-bearing assets and liabilities mature or have interest rates changing at different times or in different amounts.

In the case of variable rate assets and liabilities of the Bank are subject to basis risk, which is the difference in pricing of various variable rate indexes, such as savings rate, a six-month EURIBOR and the different types of interest. Risk management activities are aimed at optimizing net interest income in accordance with the Bank's business strategies, given the market interest rates.

The Bank has developed a policy for managing market risks, with aim to control and limit the potential loss of the Bank due to changes in foreign and domestic interest rates that affect the economic and market value of the Bank.

In order to achieve the objective of the interest rate risk management policy, the Bank identifies positions that are sensitive to interest rate changes, prepares the data for the calculation of interest-sensitive positions, establishes methods of measuring risk, establishes control mechanisms, and sets limits, determines the authorizations and responsibilities and reports.

The purpose of managing interest rate risk, as a segment of asset and liability management, is to determine the optimal interest rate, and therefore the income of the Bank, taking into account market conditions and competitive environment, while at the same time the interest rate adjusts with the Bank's assets and liabilities. Given this objective, it is important to assess the sensitivity of revenues to the rapid changes in market interest rates.

For the purpose of protection against interest rate risk exposure, the Bank contracts variable interest rates, adjusts the structure of interest-bearing assets and liabilities that accrue interest and uses other means of interest rate risk management.

The Bank manages interest risk by:

- adequately determining the level of interest margin, that is, reconciling the level of interest rates at assets and liabilities' items sensitive to interest rate, with the same maturity and time interval within which the level of interest rate is re determined, and/or
- determining maturity reconciliation of assets and liabilities sensitive to interest rate (when fixed interest rate is determined) that is, reconciles maturity (time interval for re determining of interest rates in case floating interest rate is applied).

The Bank is exposed to risks which affect its financial position and cash flows through the effects of changes in market interest rates level.

Interest rate risk presents unfavorable change of active interest rates in relation to the level of borrowings rates.

While managing interest rate risk the Bank uses simulation of expected and extreme changes in interest rates and the influence of these changes on the income statement.

Liquidity Risk Management

Definition

The Bank defines liquidity risk as the risk of not being able to meet due payment obligations on time or, in full amount; or – in the event of a liquidity crisis – only being able to procure refinancing at increased market rates, or only being able to sell assets at a discount to market prices.

General Requirements

The strategic principles of handling liquidity risks at the Bank are defined in the risk strategy. The overriding objective of liquidity risk management and controlling is to ensure that the Bank maintains its capacity to make payments and undertake refinancing activities at any time. The content-related and organizational conditions for the management and controlling of liquidity risks are governed by a liquidity manual which applies across the entire HGAA. In the Bank, liquidity steering and management are the responsibility of the Treasury function. The Treasury unit is responsible for operational liquidity steering and liquidity off-sets. Liquidity risk controlling is the responsibility of the Risk Controlling of the Bank. Risk measurement, limitation as well as timely and consistent reporting are carried out.

5. Financial Instruments (continued)

The Bank has adopted emergency liquidity planning which has been set out in written form. It sets out the processes and control or hedging instruments which are required to avert imminent or tackle acute crises. In the event of a liquidity crisis, the priorities of the Bank are to rigorously maintain the capacity to pay and to prevent damage to the Bank's reputation.

Risk Measurement

The main methodological tool for measuring, analyzing, monitoring and reporting on liquidity risk within the Bank is the liquidity overview. It is used to illustrate liquidity gaps resulting from deterministic and modeled future payment flows and the realizable liquidity coverage potential in firmly defined time frames.

The liquidity potential quantifies the capacity of the Bank – in amounts and dates – to procure liquid funds at the earliest opportunity and at cost-effective terms and conditions. It highlights possibilities regarding the coverage of liquidity gaps and hence all liquidity risks related to payment flows.

The most important components of liquidity potential are as follows:

- free access to Central bank and interbank funds,
- other available and eligible securities,
- issue potential in cover register
- senior bond issues
- committed lines of parent company, as well as
- securitization potential.

In addition to the normal scenario, other scenario analyses under stress conditions, such as name crises (rating deterioration, reputation risks) as well as market crises (restrictive funding options on capital markets, increased cash flow outflow as well as transfer limits), supplement the risk measurement spectrum.

On the basis of the liquidity overviews, key indicators are determined for the different scenarios, which allow a compact assessment of the liquidity situation. Liquidity ratios (showing tightest liquidity position) and “time-to-wall” key figures (showing maximum liquidity time horizon) for up to one year are calculated to evaluate the liquidity situation – although particular importance is attached to the utilization over the first 4 weeks.

For the purpose of limiting structural liquidity, cash value losses in the event of an increase in the funding spread due to a rating deterioration are compared in the risk-bearing capacity calculation to the economic equity.

Risk Control

A bundle of different liquidity reserves ensures that the Bank maintains its ability to pay even during crisis situations. They are subjected to different stresses in order to maintain an overview of available liquidity resources through the respective units even during crisis situations. Moreover, the Bank holds its own liquidity buffer for stress situations, composed of securities eligible in accordance with requirements of the European Central Bank (ECB) and/or securities that can be quickly liquidated as well as guaranteed interbank credit facilities.

A cash flow statement composed of deterministic, stochastic and forecast data forms the basis of this process. Short term forecast data is elicited directly from client transactions by the operating units for the purposes of short-term control, while planned budget information is used for medium-term control.

Any occurring gaps are compared to the liquidity potential – a well-diversified bundle of liquidity reserves available for liquidity management. The liquidity reserves are subjected to a regular review and stresses, depending on the market situation (as described above). Except the structure, controlling department focuses on meeting the minimum reserve as well as 1st and 2nd grade liquidity reserves.

5. Financial Instruments (continued)

Risk Monitoring

The monitoring of liquidity risk is carried out, on the one hand, on the basis of the liquidity ratio and "time-to-wall" key indicators (maximum liquidity time horizon) under normal and stress conditions, and on the other hand, through the integration of the structural liquidity risk into overall bank control (risk-bearing capacity).

Limits for short-term liquidity as well as for the limitation of long-term structural liquidity have been set, both at Group level and for the individual subsidiaries, and are monitored constantly. To ensure that existing liquidity gaps can be closed at any time through the mobilization of the liquidity potential, threshold values are being defined for all scenarios and if these are exceeded, measures must be introduced to reduce the identified liquidity risks.

The liquidity overviews as well as other relevant key indicators form a part of regular risk reports to the Management board and the controlling units responsible for liquidity risk.

Maturity Analysis for Financial Assets and Liabilities

The following table presents analysis of assets and liabilities by maturity based on remaining period from balance sheet date to agreed due date:

	In thousands of BAM				
	Up to 1 month	From 1 to 3 months	From 3 to 12 months	Over 1 year	Total
At December 31, 2011					
Financial assets					
Cash and balances with the Central Bank	245,434	-	-	-	245,434
Deposits with banks	16,337	-	-	-	16,337
Loans and advances to customers	133,741	49,666	177,529	735,517	1,096,453
Securities available-for-sale	-	9,779	4,881	794	15,454
Other financial assets	5,574	-	-	-	5,574
Total	**401,086**	**59,445**	**182,410**	**736,311**	**1,379,252**
Financial liabilities					
Deposits held by banks	45,151	25,169	8,532	362,069	440,921
Customers' deposits	227,712	113,165	124,936	77,507	543,320
Borrowings	1,363	1,389	4,744	138,765	146,261
Subordinated liabilities	-	-	-	35,470	35,470
Other financial liabilities	38,981	-	-	-	38,981
Total	**313,207**	**139,723**	**138,212**	**613,811**	**1,204,953**
Liquidity gap	**87,879**	**(80,278)**	**44,198**	**122,500**	**174,299**

5. Financial Instruments (continued)

	In thousands of BAM				
	Up to 1 month	From 1 to 3 months	From 3 to 12 months	Over 1 year	Total
At December 31, 2010					
Financial assets					
Cash and balances with the Central Bank	169,699	-	-	-	169,699
Deposits with banks	28,829	-	-	-	28,829
Loans and advances to customers	205,072	49,077	188,555	801,216	1,243,920
Securities available-for-sale	-	13	13	1,054	1,080
Other financial assets	4,908	-	-	-	4,908
Total	**408,508**	**49,090**	**188,568**	**802,270**	**1,448,436**
Financial liabilities					
Deposits held by banks	17,210	8,360	6,101	529,293	560,964
Customers' deposits	237,534	50,260	160,463	73,283	521,540
Borrowings	560	1,210	4,939	144,202	150,911
Subordinated liabilities	-	-	-	35,470	35,470
Other financial liabilities	26,927	-	-	-	26,927
Total	**282,231**	**59,830**	**171,503**	**782,248**	**1,295,812**
Liquidity gap	**126,277**	**(10,740)**	**17,065**	**20,022**	**152,624**

Fair value of Financial Assets and Liabilities

The table below summarizes the carrying amounts and fair values of financial assets and liabilities:

	In thousands of BAM			
	Carrying Value		Fair Value	
	December 31, 2011	December 31, 2010	December 31, 2011	December 31, 2010
Assets				
Deposits with banks, net	261,771	198,528	261,771	198,528
Loans and advances to customers	1,096,453	1,243,920	1,093,340	1,245,005
Liabilities				
Deposits held by banks and customers	984,241	1,082,503	982,405	1,082,649
Borrowings	146,261	150,911	146,261	150,911
Subordinated liabilities	35,470	35,470	35,470	35,470

(i) Due from Banks

Due from banks includes inter-bank placements.

Fair value of deposits with variable interest rate and "overnight" deposits is their stated value.

The estimated fair value of fixed interest-bearing deposits not quoted in an active market is based on discounted cash flows using interest rates for new debts with similar remaining maturity.

5. Financial Instruments (continued)

(ii) Loans and advances to customers, net

Loans are presented net of charges for impairment. The estimated fair value of loans represents the discounted amount of estimated future cash flows expected to be received. Expected cash flows are discounted at current market rates to determine fair value.

(iii) Deposits from other banks, clients, other deposits, other borrowings and subordinated liabilities

The estimated fair value of deposits with no stated maturity, which includes non-interest bearing deposits, is the amount repayable on demand. The estimated fair value of fixed interest-bearing deposits not quoted in an active market is based on discounted cash flows using interest rates for new debts with similar remaining maturity.

Fair value of term deposits with variable interest rate approximates the carrying value as of reporting date.

Subordinated liabilities with variable interest rate approximate the carrying value as of reporting date.

Operational Risks

Operational risk management is an important part of the Bank's operations, which allows its long-term successful business and the preservation of reputation.

As part of operational risk framework, the Bank implemented the following activities:

- definition and identification of operational risk;
- development and application of methods and systems for measurement, analysis, limitations and control of operational risks in accordance with regulatory and Group requirements;
- measurement, analysis and supervision of operational risk in line with minimum standards for operational risk management;
- maintenance of database on losses from operational risks – regular data collection and reporting on incidents;
- regular updates of new and existing policies, manuals and procedures in accordance with regulations and Group standards;
- managing the Business Continuity Plan; and
- education of employees on dealing with operational risks.

In order to improve processes for managing operational risk in the Bank, the following activities are planned:

- initiation of activities for adequate operational risk management for all projects and development of new products, processes and systems;
- testing the Business Continuity Plan;
- education of employees involved in issuing the Reports and all employees of the Bank.

e) Capital Risk Management

In accordance with the Law on Banks (Official Gazette of the Republic of Srpska 44/03), the minimum amount of a bank's paid-in capital and the lowest level of the capital a bank has to maintain, cannot be lower than BAM 15,000 thousand. The Bank's equity is BAM129,168 and it is in line with these provisions.

The Bank's capital is comprised of the core capital less items deductible from the core capital and supplementary capital.

5. Finansijski instrumenti (nastavak)

The Bank's core capital is comprised of paid-in share capital and reserves. Deductible items include: intangible assets, unabsorbed losses from prior years and current year loss, the carrying value of the Bank's own treasury shares and the amount of additional reserves for credit losses as per requirements of the BARS regulations.

The Bank's supplementary capital includes general provisions for credit losses on balance sheet items from A category, current net profit reviewed and confirmed by an independent auditor and subordinated debt up to 50% of the core capital.

With regard to capital risk management, the Bank aims to:

- provide consistency with the BARS requirements;
- provide consistency with Hypo Group standards;
- provide solid equity basis as a support for further development of Bank's operations;
- provide possibilities of long-term business operation while providing income for shareholders.

The Bank is under obligation to maintain capital adequacy at the minimum of 12% and the core capital at the minimum of 50% of the total equity, i.e. to adjust the scope and structure of its operations to business indicators defined by the Decision on Minimum Standards for Bank Capital Management and other BARS decisions relating to supervision and control of banks performance and Law on Banks of the Republic of Srpska.

The Bank manages capital and performs reconciliations in accordance with its goals, market changes and risks typical for Bank's operations. Depending on the primary goal, the Bank adjusts capital structure as follows:

- by adjustments of dividend payments to shareholders, i.e., by increase in share capital arising from profit;
- by increase of capital reserves arising from profit;
- by new issues of shares which can be private and public;
- by increase in additional equity items.

As of December 31, 2011 and December 31, 2010, the Bank's capital adequacy indicators were in compliance with applicable regulations.

	In thousands of BAM	
	Year Ended December 31,	
	2011	2010
Core capital	135,702	137,131
Supplementary capital	76,381	54,521
Items deductible from capital	(238)	(1,743)
Capital, net	**211,845**	**189,909**
Total risk-weighted assets	989,397	1,173,531
Total risk-weighted off-balance sheet items	66,197	70,442
Weighted operational risk	95,380	93,429
Total risk-weighted assets and off-balance sheet items	**1,150,974**	**1,337,402**
Capital adequacy as of December 31	**18.4%**	**14.2%**

6. Interest Income and Expense

Interest Income

	In thousands of BAM	
	Year Ended December 31,	
	2011	2010
Loans to retail customers	44,228	47,178
Loans to corporate and public sector customers	39,194	44,884
Balances with the Central Bank	1,186	585
Deposits with banks	85	193
	84,693	92,840

Interest Expenses

	In thousands of BAM	
	Year Ended December 31,	
	2011	2010
Deposits held by banks and other financial institutions	25,467	23,956
Deposits from retail customers	10,374	10,745
Deposits from public sector	2,371	3,015
Deposits from corporate customers	2,021	2,407
Other deposits	92	124
	40,325	40,247

7. Fee and Commission Income and Expense

Fee and Commission Income

	In thousands of BAM	
	Year Ended December 31,	
	2011	2010
Fee income arising from domestic payment transfers	6,012	5,427
Fee earned on VISA card operations	2,467	2,360
Fee income arising from international payment transfers	1,880	2,056
Charges for early loan repayment and notice sending	973	916
Commission from issued guarantees, letters of credit and other sureties	788	819
Fee income from currency conversion operations	739	438
Brokerage commissions	88	95
Other fee and commission income	308	290
	13,255	12,401

7. Fee and Commission Income and Expense (continued)

Fee and Commission Expenses

	In thousands of BAM	
	Year Ended December 31,	
	2011	2010
Fees for funds available for liquidity purposes	1,956	1,792
Fee expense incurred on payment card operations	728	631
Fees from loans, issued guarantees and other fees	620	591
Fee expense incurred on domestic payment transfers	674	486
Fee expense incurred on international payment transfers	148	122
Fee expense incurred on stock exchange operations and Central Register fees	20	24
	4,146	3,646

8. Other Operating Income

	In thousands of BAM	
	Year Ended December 31,	
	2011	2010
Collection of receivables previously written-off	12,493	9,765
Rental income	652	590
Income from dividends	-	114
Income from dormant customer current accounts	398	95
Reversal of provisions for retirement benefits and unused compensated absences (Note 23)	74	30
Income from the sale of securities available-for-sale	372	9
Reversal of provisions for employee bonuses	2,445	-
Reversal of provisions for litigation losses	110	-
Fair value adjustment of the acquired tangible assets	15	-
Other income	821	170
	17,380	10,773

Income from dormant accounts relates to accounts where there has been no account holder activity, either deposit to or withdrawal from the account by the account holder, for a period of one year from the date of the last account holder activity, and in the case of time deposits, one year beyond the maturity date, in accordance with the Law on Banks of the Republic of Srpska.

9. Other Operating Expenses

	In thousands of BAM	
	Year Ended December 31,	
	2011	2010
Net salaries	8,770	8,905
Taxes and contributions on salaries	6,781	6,031
Other employee benefits	1,449	2,323
Fair value adjustment of the acquired tangible assets	365	6,184
Provisions for potential litigation losses (Note 28)	479	5,176
Depreciation and amortization	3,687	3,762
Costs of materials, fuel, energy and services	1,815	1,830
Software lease costs	4,320	1,556
Property insurance and security	2,954	2,893
Telecommunications	1,783	1,650
Advertising, marketing and entertainment	2,154	1,460
Fees to the Banking Agency of the Republic of Srpska	1,263	1,241
Maintenance	914	1,166
Indirect taxes and contributions	1,825	950
Provisions for other liabilities (Note 28)	-	813
Professional services by related banks	1,381	677
Consulting services	1,757	114
Rentals	690	640
Revaluation of property	-	635
Court expenses	354	477
Per diems and other travel costs	434	456
Sponsorship and humanitarian aid	481	270
Non-material expenses	933	162
Membership fees and commissions	133	131
Losses on the sale of securities available-for-sale	70	-
Disposals and write-offs of property and equipment	6	11
Other expenses	736	308
	45,534	49,821

10. Provisions Against Credit Risk and Potential Losses

	In thousands of BAM	
	Year Ended December 31,	
	2011	2010
Loans and advances to customers (Note 14)	(720)	72,920
Other assets (Note 20)	-	(12)
Provisions for commitments and contingencies (Note 28)	1,368	(1,749)
Deposits with banks (Note 13)	(1)	1
Direct write-offs	115	266
	762	71,426

11. Income Taxes

a) Components of Income Tax

	In thousands of BAM	
	Year Ended December 31,	
	2011	2010
Current income tax expense	2,532	3,247
Deferred tax expense/(income)	322	(23)
	2,854	3,224

b) Reconciliation between tax expense and the product of the accounting results multiplied by the applicable tax rate

	In thousands of BAM	
	Year Ended December 31,	
	2011	2010
Profit/ (Loss) before taxation	26,097	(45,426)
Income taxes at the statutory tax rate of 10%	2,610	(4,543)
Adjustments		
Tax effects of expenses not recognized for tax purposes	689	8,474
Tax effects of income not recognized for tax purposes	(170)	(90)
Tax effect of recognized provisions for potential losses representing 20% of the tax basis	(65)	(649)
Non-deductible entertainment costs	6	3
Non-deductible penalties	3	35
Tax effects of depreciation and amortization not recognized for tax purposes	29	10
Tax effects of provisions for employee benefits	(248)	(16)
Income tax expense	**2,854**	**3,224**
Effective interest rate	11%	(7%)

Tax effect of expenses not included in determining taxable profit in the amount of BAM 689 thousand represents 10% of expenses not recognized for tax purposes, in accordance with the Law on Corporate Income Tax of the Republic of Srpska, including risk provision charges, other provision charges, impairment losses from revaluations and various other expenses.

12. Cash and Balances Held With the Central Bank

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Cash on hand:		
- in local currency	12,764	10,224
- in foreign currencies	9,663	11,076
Balances with the Central Bank (in local currency)		
- obligatory reserve	90,423	104,986
- gyro account	132,584	43,413
	245,434	169,699

Cash and balances with Central Bank as of December 31, 2011 include related interest and fee in total amount of BAM 33 thousand (2010: BAM 35 thousand).

The legally prescribed required reserve represents amounts required to be deposited with the Central Bank of Bosnia and Herzegovina. Pursuant to the Law on the Central Bank of Bosnia and Herzegovina, starting from February 1, 2011, the required reserve represents 10% of average ten-day deposits and borrowings with maturities within one year and 7% of those denominated in BAM with maturities over a year.

The required reserve is maintained as the average balance on the current account with the Central Bank of Bosnia and Herzegovina.

This reserve is available for liquidity purposes. The Central Bank of Bosnia and Herzegovina pays a fee on the obligatory reserve in the manner specified by Law.

13. Deposits With Banks

	In thousands of BAM	
	December 31, 2011	December 31,2010
Foreign currency accounts with foreign and domestic banks	8,308	7,115
Up to 7 days term deposits	7,940	21,632
Foreign currency cheques in the course of collection	91	84
Less: Allowance for impairment	(2)	(2)
	16,337	28,829

Foreign currency accounts held with foreign and domestic banks do not accrue interest.

As of December 31, 2011, term deposits with maturity up to 7 days relate to deposits in banks in the European Union bearing interest at the annual rates ranging from 0.20% to 0.25% (2010: 0.24% to 0.25% annually).

The movements on the account of allowance for impairment are presented in the following table:

	In thousands of BAM	
	December 31, 2011	December 31,2010
Balance at January 1	2	4
Charge for the year	1	83
Reversal	(1)	(82)
Charge for the year, net	-	1
Foreign exchange gains/losses, net*	-	(3)
Balance at December 31	2	2

*Starting from January 1, 2010, in accordance with the local regulations, the Bank calculates risk provisions in original currency and discloses net foreign exchange gains and losses, separately from the related provision charge.

14. Loans and Advances to Customers

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Up to 1 year maturity:		
- in local currency	231,811	293,694
- in foreign currency	7,032	14,441
Over 1 year maturity:		
- in local currency	782,396	908,280
- in foreign currency	2,630	3,004
Current portion of long-term loans:		
- in local currency	145,742	189,508
- in foreign currency	342	288
Receivables arising on guarantees issued:		
- in local currency	309	2,130
- in foreign currency	-	3,462
	1,170,262	1,414,807
Less: Allowance for impairment	(73,809)	(170,887)
	1,096,453	1,243,920

Loans and advances to customers as of December31, 2011 include related interest and fees in the total amount of BAM 13,402 thousand (2010: BAM 26,928 thousand).

Ranges of interest rates on loans stated in the text below refer to the prevailing interest rates representing the most part of loans.

The majority of BAM loans with maturities up to one year relate to overdrafts on current accounts extended to corporate customers of BAM 101,491 thousand (2010: BAM 98,891 thousand), approved at annual interest rates ranging from 4.25% to 15.49% (2010: from 4.25% to 15.49% annually).

The movements on the account of allowance for impairment are presented in the following table:

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Balance at January 1	170,887	101,712
Charge for the year	100,708	111,895
Reversal	(101,456)	(38,975)
Charge for the year, net	(748)	72,920
Foreign exchange, net*	744	2,396
Pass-Through Agreement	(87,675)	-
Write-off	(9,399)	(6,141)
Balance at December 31	**73,809**	**170,887**

* Charge for the year includes the foreign exchange impact per item.

The remaining part mainly relates to short-term loans extended to enterprises in the amount of BAM 55,863 thousand with annual interest rates ranging from 4% to 11.50% (2010: BAM 57,523 thousand with annual interest rates ranging from 4% to 11.50%), short-term consumer loans approved to retail customers in the amount of BAM 23,092 thousand, with annual interest

14. Loans and Advances to Customers (continued)

rates ranging from 6% to 13.99% (2010: BAM 20,664 thousand with annual interest rates ranging from 6% to 13.99%) and short term loans to SME customers in the amount of BAM 233 thousand, with annual interest rates ranging from 7.50% to 11.50% (2010: BAM 61 thousand with annual interest rates ranging from 9.10% to 11.50%). The remaining BAM 51,132 thousand (2010: BAM 116,555 thousand) refer to matured long-term loans approved to corporate and retail customers in the amount of BAM 39,937 thousand and the related interest payables of BAM 11,195 thousand.

Loans disbursed in BAM with over 1 year maturities relate to loans approved to corporate customers at annual interest rate ranging from 6-month EURIBOR plus the margin of minimum 2.75% to 6-month LIBOR plus the margin of minimum 4%, and loans approved to retail customers at annual interest rates ranging from 2% to 13.99% (2010: interest rate ranging 6-month EURIBOR plus the margin of minimum 2.75% to 6-month LIBOR plus the margin of minimum 4%, and 2% to 13.99% annually).

As of December 31, 2011, loans disbursed in BAM with over 1 year maturities included loans approved to retail customers totaling BAM 489,525 thousand (including the current portion thereof) (2010: BAM 515,075 thousand). The review of loans is presented in the following table:

	In thousands of BAM		
	Maturity	Interest Rate	Total
December 31, 2011			
Consumer loans	Do 10 godina	5.4 % - 14.49 %	220,858
Housing loans	Do 30 godina	3.60 % -11.75%	161,593
Mortgage and Lombard loans	Do 20 godina	2.50 % -11.75 %	65,278
Investment loans	Do 10 godina	4.20 % -11.50 %	25,788
Loans to the bank's employees	Do 30 godina	2.00 % -11.25 %	15,273
Automobile purchase loans	Do 10 godina	7.20 % -10.75 %	735
			489,525
December 31, 2010			
Consumer loans	Do 10 godina	5.99 % -13.99 %	232,856
Housing loans	Do 30 godina	3.60 % -11.25%	166,907
Mortgage and Lombard loans	Do 20 godina	2.50 % -11.75 %	70,572
Investment loans	Do 10 godina	4.75 % -15.50 %	28,227
Loans to the bank's employees	Do 30 godina	2.00 % -11.25 %	15,226
Automobile purchase loans	Do 10 godina	7.20 % -10.75 %	1,287
			515,075

In 2011 there was an evident decrease in loans extended to customers as compared to the year 2010. Out of the total decrease amount, BAM 162,207 thousand resulted from the Pass-Through Agreement (PTA). The agreement includes non-performing loans and released capital for financing and placing new loans. As of December 22, 2011, the Pass-Through Agreement was entered into by Hypo Alpe-Adria Bank a.d, (hereinafter: the "Transferor"), Bora d.o.o., Banja Luka (hereinafter: the "Transferee") and Hypo Alpe-Adria Bank International AG (hereinafter: the „"Calculation Agent"). Pursuant to this Agreement, the Transferor undertakes to transfer all cash flows from the financial assets included in the Agreement (hereinafter: "reference assets") without any significant delays. Cash flows include all amounts realized through sales of the assets collateralizing the reference assets the Transferor purchased within the court execution procedure or directly from the owner, out of court execution procedure.

The Transferor is entitled to deduction of real costs incurred in collection of receivables if the costs are documented to the Transferee. The transfer of cash flows is performed in BAM calculated at the middle exchange rate published by CBBH as at the date of each transfer. The Transferee is entitled to interest accrued during the period from the receipt of the cash flows by the Transferee up to the transfer of the cash flows to the Transferee's account at the interest rate theTransferee calculates for demand deposits in accordance with the Decision on Interest Rates in Transactions with Legal Entities. The fee for cash flows the Trans

14. Loans and Advances to Customers (continued)

feree is obligated to pay is determined as a net carrying value of the reference assets (gross carrying value netted of allowance for impairment).

PTA has no impact on the relationships between the Bank and its customers whose loans are the subject of the PT Agreement. The Agreement transfers all the risks and rewards of collection to the Transferee whereby the Transferee is obligated to manage and service the reference assets with the due care attention and skills that would have been exercised thereto had this Agreement not been entered into. Based on this Agreement, the Bank has derecognized all the reference assets from the balance sheet, together with related allowance for impairment, and decreased liabilities arising from deposits to Hypo Alpe-Adria Bank International AG by the net amount.

The review of the reference assets is presented in the following table:

	In thousands of BAM		
	Balance Sheet Item Exposure	Allowance for Impairment	Net Value
Amount per PTA			
Balance at October 31, 2011	251,537	(78,628)	172,909
Balance at December 31, 2011	249,882	(87,675)	162,207
			10,703

Given that the basis for the PTA was the net value as of October 31, 2011, and that the Agreement defined as the basis the net value as of December 31, 2011, in the meantime there arose differences resulting from several factors: decrease in gross exposure due to improved customers' repayments, foreign exchange effects of the receivables in foreign currency and receivables index-linked to CHF by foreign currency clause and changes in the allowance for impairment. The difference of BAM 10,703 thousand increased by the exchange rate effect (of BAM 179 thousand) realized in the period from November 1 to December 31, 2011 was recorded in the transaction deposit account; by the amount of this difference (BAM 10,882 thousand) the deposit to Hypo Alpe-Adria Bank International AG will be increased upon the compilation of Annex 1 in 2012.

The geographic sector risk concentrations within the customer loan portfolio mostly relates to clients domiciled in the Republic of Srpska.

15. Securities Available-for-Sale

	In thousands of BAM	
	December 31, 2011	December 31,2010
Investments in associates		
- Kristal Konsalting a.d., Banja Luka	-	151
Investments in financial institutions		
- Euroaxis Bank, Moscow, Russia	353	344
- Banjalučka berza a.d., Banja Luka	175	175
- Kristal Invest a.d., Banja Luka	-	78
- Central Securities Registry a.d., Banja Luka	30	30
- Other financial institutions	141	145
Investments in non-financial entities	26	26
Investments in debt securities	14,729	131
	15,454	1,080

As of February 8, 2011, the Bank's Supervisory board decided to sell the Bank's shares in Kristal Konsalting a.d. Banja Luka for BAM 80 thousand and shares in Kristal Invest a.d., Banja Luka for BAM 530 thousand to a private investor.

16. Equity Investments

Equity investments as of December 31, 2011 in the amount of BAM 2,500 thousand relate to the 100% equity share in the related party Hypo Alpe-Adria-Leasing d.o.o., Banja Luka, which was established in June 2011 and engages in lease activities. In the 2nd extraordinary meeting held on May 24, 2011, the Shareholders' Assembly of Hypo Alpe-Adria-Bank a.d. Banja Luka enacted a Decision on the foundation of Hypo Alpe-Adria-Leasing d.o.o. Banja Luka.

17. Property And Equipment

	In thousands of BAM			
	Land and Buildings	Equipment and Other Assets	Investments in Progress	Total
Cost				
Balance at January 1, 2010	48,755	16,446	16,446	66,378
Additions	28	185	185	1,211
Transfers	1,373	493	493	-
Disposal	-	-	-	(5)
Valuation:	(2,517)	-	-	(2,517)
- Write-off	-	(689)	(689)	(689)
- Sales	-	(181)	(181)	(181)
Balance at December 31, 2010	**47,638**	**16,254**	**304**	**64,197**
Additions	-	402	-	1,271
Transfers	93	506	-	-
Disposal	-	(104)	-	(104)
- Write-off	-	(1,337)	-	(1,337)
Reclassification	-	-	-	(1)
Balance at December 31, 2011	**47,731**	**15,721**	**-**	**64,026**
Accumulated depreciation				
Balance at January 1, 2010	8,676	6,672	-	15,348
Charge for the year	665	2,419	-	3,084
Revaluation	(2,718)	-	-	(2,718)
- Write-off	-	(679)	-	(679)
- Sales	-	(161)	-	(161)
Balance at December 31, 2010	**6,623**	**8,251**	**-**	**14,874**
Charge for the year	657	2,362	-	3,019
Disposal	-	(98)	-	(98)
- Write-off	-	(1,337)	-	(1,337)
Balance at December 31, 2011	**7,280**	**9,178**	**-**	**16,458**
Net book value:				
December 31, 2011	**40,451**	**6,543**	**574**	**47,568**
December 31, 2010	**41,015**	**8,003**	**304**	**49,323**

17. Property And Equipment (continued)

The Bank's property as of December 31, 2011, included land and buildings with carrying amount of BAM 2,741 thousand, whereof the Bank did not possess appropriate title deeds (2010: BAM 2,706 thousand).

As of December 31, 2011, the Bank had no mortgages or other pledges assigned over its property and equipment as collaterals for loan repayment.

18. INTANGIBLE ASSETS

	In thousands of BAM
	Licenses and Software
Cost	
Balance at January 1, 2010	7,726
Additions	6,798
Write-off	(370)
Balance at December 31, 2010	**4,154**
Additions	1,390
Write-off	(55)
Reclassification	(54)
Balance at December 31, 2011	**15,435**
Accumulated amortization	
Balance at January 1, 2010	1,261
Charge for the year	621
Write-off	(370)
Balance at December 31, 2010	**1,512**
Charge for the year	614
Write-off	(55)
Balance at December 31, 2011	**2,071**
Net book value:	
December 31, 2011	**13,364**
December 31, 2010	**12,642**

19. Investment Property

	In thousands of BAM
	Land and Buildings
Cost	
Balance at January 1, 2010	4,096
Revaluation	(201)
Balance at December 31, 2010	**3,895**
Balance at December 31, 2011	**3,895**
Accumulated depreciation	
Balance at January 1, 2010	446
Charge for the year	57
Revaluation	(218)
Balance at December 31, 2010	**285**
Charge for the year	54
Balance at December 31, 2011	**339**
Net book value:	
December 31, 2011	**3,556**
December 31, 2010	**3,610**

As of December 31, 2011, investment property was comprised of land with carrying value of BAM 111 thousand, whereof the Bank did not possess appropriate title deeds (2010: BAM 113 thousand).

20. Other Assets

	In thousands of BAM	
	December 31, 2011	December 31, 2010
In local currency:		
- Receivables from clients arising from litigations	1,453	1,453
- Foreclosed assets received in collection of receivables	1,613	1,446
- Collateral foreclosures	1,264	962
- Deferred tax assets	668	540
- Receivables from income taxes	531	531
- Credit card operations	561	377
- Prepaid expenses	24	338
- Consumables, tools and fixtures	233	280
- Advances paid	2	23
- Rental receivables from clients	74	55
- Prepaid interest	-	18
- Other receivables	1,331	877
In foreign currencies:		
- Credit card operations	886	496
- Prepaid expenses	28	76
- Prepaid interest	4	46
- Other receivables	174	514
Less: Allowance for impairment	(1,425)	(1,397)
	7,421	6,635

As of December 31, 2011, the amount of BAM 2,377 thousand refers to non-financial assets and allowance for impairment thereof in the amount of BAM 531 thousand (2010: BAM 2,257 and BAM 531 thousand, respectively) out of total other assets.

The movements on the account of allowance for impairment are presented in the following table:

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Balance at January 1	1,397	1,409
Charge for the year	28	-
Reversal	-	(12)
(Decrease)/increase, net	28	(12)
Balance at December 31	**1,425**	**1,397**

21. Deposits Held by Banks and Other Financial Institutions

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Demand deposits in local currency:		
- domestic banks and financial institutions	16,814	15,001
- related banks and financial institutions	709	-
Demand deposits in foreign currencies:		
- related banks and financial institutions	1,021	512
- domestic banks and financial institutions	3,782	372
Short-term deposits in local currency:		
- domestic banks and financial institutions	13,286	7,460
Short-term deposits in foreign currencies:		
- related banks and financial institutions	27,339	-
Long-term deposits in local currency:		
- domestic banks and financial institutions	11.323	5,670
Long-term deposits in foreign currencies:		
- financial institutions	13,571	11,691
- related banks	353,076	520,258
	440,921	560,964

Deposits held by banks and other financial institutions as of December 31, 2011 included the related interest in the amount of BAM 511 thousand (2010: BAM 372 thousand).

Long-term deposits in foreign currencies totaling BAM 353,076 thousand relate to deposits held by Hypo Alpe-Adria-Bank International AG, Klagenfurt with 23 to 84 month maturity at interest rates index-linked to EURIBOR/LIBOR (1M, 3M, 6M,1Y and 7Y) as increased by the margin of 0.9% to 4% (2010: 0.9% to 2.13% p.a.). A short-term foreign currency deposit in the amount of BAM 27,339 thousand is the deposit held by Hypo Alpe-Adria-Bank International AG, Klagenfurt, with 1 day to 6 month maturity at an interest rate index-linked to overnight/EURIBOR as increased by the margin of 0.9% to 3.26%.

22. Customers' Deposits

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Demand deposits in local currency:		
- Corporate customers	30,949	27,711
- Government institutions and agencies	26,771	30,513
- Foreign entities	1,907	1,330
- Other customers	9,031	9,069
- Retail customers	69,321	64,751
Demand deposits in foreign currencies:		
- Corporate customers	7,127	6,701
- Government institutions and agencies	31	62
- Foreign entities	2,653	2,590
- Other customers	617	629
- Retail customers	58,695	56,596
Short-term deposits in local currency:		
- Corporate customers	2,264	1,122
- Government institutions and agencies	402	-
- Other customers	342	349
- Retail customers	8,529	10,137
Short-term deposits in foreign currencies:		
- Corporate customers	5,657	11,302
- Government institutions and agencies	7,912	35,988
- Other customers	-	226
- Retail customers	22,481	38,809
Long-term deposits in local currency:		
- Corporate customers	8,240	9,125
- Government institutions and agencies	1,013	1,286
- Other customers	573	634
- Retail customers	37,307	26,163
Long-term deposits in foreign currencies:	-	-
- Corporate customers	10,406	5,603
- Government institutions and agencies	51,240	41,751
- Other customers	923	1,122
- Retail customers	178,929	137,971
	543,320	521,540

Customers' deposits as of December 31, 2011 include the related interest in the total amount of BAM 1,666 thousand (2010: BAM 1,680 thousand).

BAM demand deposits represent the balances of local currency transaction accounts of the Bank's corporate clients, Government agencies and other organizations. The Bank calculates interest to these at annual rates ranging from 0% to 3.6% (2010: 0.1% to 4.1% annually). In accordance with the Bank's business policy, foreign currency demand deposits accrue interest at annual interest rates ranging from 0% to 3.30% (2010: 0.1% to 3.85% annually).

22. Customers' Deposits (continued)

In accordance with the Bank's business policy, the Bank calculates interest to short-term retail customers' deposits both in local and foreign currencies at annual interest rates ranging from 0.15% to 6.50%, depending on their maturity and currency (2010: 0.1% to 3.85% annually). Out of total short-term deposits as of December 31, 2011, the amount of BAM 3,653 thousand represents monetary security for the loans approved and guarantees issued by the Bank (2010: BAM 3,668 thousand).

The Bank calculates interest to long-term local and foreign currency deposits at annual rates ranging from 0% to 6.75%, depending on their maturities and currency (2010: 0.45% to 5.1% annually). Out of total short-term deposits as of December 31, 2011, the amount of BAM 11,305 thousand represents monetary security for the loans approved and guarantees issued by the Bank (2010: BAM 6,323 thousand).

23. Borrowings

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Long-term foreign currency borrowings:		
European Investment Bank, Luxembourg	49,140	49,062
Council of Europe Development Bank, France	11,094	19,614
	60,234	68,676
Long-term BAM borrowings:		
Housing Fund of the Republic of Srpska	39,672	38,144
Republic of Srpska Development and Employment Fund, Banja Luka	30,253	31,823
Fund for Development of Eastern Region of the Republic of Srpska, Banja Luka	16,102	12,268
	86,027	82,235
	146,261	150,911
Current portion of long-term borrowings	7,204	6,487

As of December 31, 2011, the Bank's liabilities arising from borrowings included related interest in the total amount of BAM 292 thousand (2010: BAM 222 thousand).

European Investment Bank, Luxembourg loan was disbursed to the Bank for financing investments in legal entities. It is repayable in two equal tranches on March 23, 2015 and March 23, 2017, bearing interest at the rate of 6-month EURIBOR + 0.094% and 0.119% annually (2010: 1.23% and 1.25% annually).

Council of Europe Development Bank, France approved a loan to the Bank for financing loans to SME customers. Loan repayment is performed in 40 equal monthly installments within the period from January 6, 2011 untill October 6, 2020. Interest is charged at the rate of 3-month EURIBOR increased by the margin of 0.18% annually.

Republic Srpska Development and Employment Fund, Banja Luka financed development projects. The repayment was agreed in accordance with the repayment schedules to the end users of the loans. Interest is charged at the rate of 6-month EURIBOR reduced in accordance with the criteria for reduction of interest rates on Investment development bank of the Republic of Srpska (IDB RS a.d.), Banja Luka credit facilities.

Fund for Development of the Eastern Region of the Republic of Srpska, Banja Luka loan was disbursed for providing support to development projects in the eastern part of the Republic of Srpska. The repayment was agreed in accordance with the repayment schedules to the end users of the loans. Interest is charged at the rate of 6-month EURIBOR reduced in accordance with the criteria for reduction of interest rates on IDB RS a.d., Banja Luka credit facilities.

23. Borrowings (continued)

Housing Fund of the Republic of Srpska, Banja Luka has provided a loan to the Bank for financing the purchase of state-owned flats. The repayment was agreed in accordance with the repayment schedules to the end users of the loans. Interest is charged at the rate of 6-month EURIBOR reduced in accordance with the criteria for reduction of interest rates on IDB RS a.d., Banja Luka credit facilities.

24. Subordinated Liabilities

Subordinated liabilities (debt) in the amount of BAM 35,470 thousand as of December 31, 2011 refer to the funds received from the Bank's major shareholder Hypo Alpe-Adria-Bank International AG Klagenfurt in the equivalent amount of EUR 18,135,502 based on the Subordinated Debt Agreement dated December 31, 2008. Pursuant to the Decision 03-1408-4/08 dated December 18, 2008, the Banking Agency of the Republic of Srpska gave pre-approval for the inclusion of the subordinated debt in the Bank's supplementary capital. According to the agreement, subordinated debt bears interest at the rate of EURIBOR + 7% annually. Another Subordinated Debt Agreement was signed on September 30, 2010. Pursuant to the Decision 03-1060-4/108 dated September 29, 2010 the Banking Agency of the Republic of Srpska gave pre-approval for the inclusion of the subordinated debt in the Bank's supplementary capital. The subordinated debt is deposited for an indefinite period and the Bank is not obliged to repay the deposited amount. According to the agreement, subordinated debt bears fixed interest of 10% annually.

25. Other Liabilities

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Liabilities in local currency:		
Deferred other fees	8,142	8,954
Early loan repayments	8,298	7,857
Payables to employees	2,288	3,921
Liabilities for taxes and contributions	2,367	2,949
Deferred interest income	640	735
Accounts payable	798	359
Unrealized payments for establishment of companies	129	156
Deferred tax liabilities	878	192
Accrued expenses	132	100
Liabilities for dividends	70	71
Employee benefits: unused short-term absences, vacations	76	63
Other liabilities	2,536	1,135
Foreign currency liabilities:		
PTA liabilities to the parent bank	10,882	
Accounts payable	1,636	277
Deferred other fees	46	52
Early loan repayments	21	15
Other liabilities	42	91
	38,981	26,927

25. Other Liabilities (continued)

Movements in the account of provisions for unused short-term absences-vacations are presented in the following table:

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Balance at January 1	63	78
Charge for the year	13	-
Reversal	-	(15)
Balance at December 31	**76**	**63**

26. Share Capital

The Bank's share capital includes initial shareholder investments and subsequent share emissions. The Bank's shareholders are entitled to participation in the management of the Bank, as well as in the distribution of profit.

As of December 31, 2011, the Bank's share capital was comprised of 129,167,785 common shares with an individual par value of BAM 1 (2010: 175,511,897 common shares). All of the Bank's shares have been fully paid up.

Pursuant to the Shareholders' Assembly Decision on the 12th share issue without a full prospectus numbered S-4 /2011. And dated May 12, 2011, a share capital decrease procedure was initiated. The Bank's core capital totaling BAM 175,512 thousand as of the decision enactment date was decreased by the amount of BAM 46,344 thousand and after decrease amounted to BAM 129,168 thousand.

The capital decrease procedure was completed and, at the end of 2011, the capital decrease registration process was commenced. However, as of December 31, 2011, the registration process was still underway. It was recorded in the competent court registry under Decision of the County Commercial Court numbered 057-0-REG-11-002308 and dated February 22, 2012.

As of December 31, 2011. The Bank's majority shareholder was Hypo Alpe-Adria-Bank International AG Klagenfurt, with 99.73% equity share (December 31, 2010: 99.71%).

27. Earnings/(Loss) Per Share

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Profit /(Loss)	23,242,849	(48,650,424)
Weighted average number of shares	160,021,536	126,926,109
Basic (loss)/earnings per share in BAM	**0.145**	**(0.383)**

The Bank has no dilutive potential ordinary shares such as convertible debt and share options. Therefore, the Bank does not calculate diluted earnings per share.

28. Other Provisions

As of December 31, 2011, other provisions were as follows:

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Litigations	5,476	5,176
Restructuring	1,027	1,227
Other provisions	47	813
Retirement benefits	383	383
	6,933	7,599
Provision for contingent liabilities	2,066	702
	8,999	8,301

	In thousands of BAM				
	Restructuring	Retirement Benefits	Litigations	Other	Total
Balance at January 1, 2011	**1,227**	**383**	**5,176**	**813**	**7,599**
Charge for the year	-	90	478	-	568
Reversal	-	(75)	(110)	(11)	(196)
Payments	(200)	(15)	(68)	(755)	(1,038)
Balance at December 31, 2011	**1,027**	**383**	**5,476**	**47**	**6,933**

Increases in provisions for litigations and other provisions are included in Other operating expenses, Note 9. Movements in the account of provisions for contingent liabilities are presented in the following table:

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Balance at January 1	702	2,451
Charge for the year	3,261	1,444
Reversal	(1,893)	(3,193)
Increase/(decrease) in provisions, net	1,368	(1,749)
PTA Agreement	(4)	-
Balance at December 31	2,066	702

29. Commitments and Contingent Liabilities

Loans, guarantees, performance bonds and letters of credit

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Loan commitments	80,709	74,618
Payment guarantees	29,941	34,325
Performance bonds	3,861	3,499
Letters of credit and other sureties	899	566
	115,410	113,008

Litigation

As of December 31, the Bank had court execution procedures, lawsuits and bankruptcy procedures in progress for the purpose of collection of its receivables end exercise of other rights and interests. Certain number of administrative proceedings were also initiated for the purpose of nullification of acts enacted in administrative procedures. At the same date, the Bank was involved in a certain number of lawsuits filed against it by legal entities and individuals.

In order to collect its receivables, which relate to loans, issued guarantees and letters of credit, the Bank was engaged in 1,045 legal proceedings as of December 31, 2011, with the total value of BAM 224,497 thousand.

As of December 31, 2011, the legal proceedings filed against the Bank amounted to BAM 65,406 thousand. This amount does not include any penalty interest that might be assessed, given that the Bank's management was unable to estimate with any certainty the possible effects of penalty interest as of the date of issuance of these financial statements. The Bank's management estimates that the final outcome of the filed legal proceedings will be favorable, and that no material losses will result from the settlement of the aforementioned litigations. Accordingly, as of December 31, 2011, the Bank created provision against potential losses thereof in the amount of BAM 5,476 thousand (December 31, 2010: BAM 5,176 thousand).

The Bank constantly monitors legal risks, and evaluates the expected legal proceedings expenses, and creates adequate provisions thereof (Note 28).

Based on the above fact, none of the proceedings initiated against the Bank are significant enough to jeopardize the Bank's operations.

Compliance with Laws and Regulations

The bank is obligated to adjust the scope and structure of its operations to business indicators defined by the Decision on Minimum Standards for Bank Capital Management and other BARS decisions relating to supervision and control of banks performance and Law on Banks of the Republic of Srpska.

As of December 31, 2011, the Bank was in full compliance with the accounting standards and regulations of the Republic of Srpska defined by the Banking Agency of the Republic of Srpska.

Capital Expenditure

Based on the concluded Agreement on Implementation of New T24+ Software, the Bank continued regular servicing of liabilities to Zajednički informacioni sistemi d.o.o., Beograd, a related party, in the amount of BAM 1,016 thousand in 2011 (amount defined for settlement after the first round of user testing). The remaining part of the investment in the year 2012 is to be repaid in two installments, following the Go-live date (May 7, 2012) and following the stabilization period.

30. Related Party Transactions

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Assets:		
Foreign currency accounts:		
- HYPO ALPE-ADRIA-BANK International AG, Klagenfurt, Austria	2,897	4,798
- HYPO ALPE-ADRIA-BANK d.d., Ljubljana, Republic of Slovenia	164	249
- HYPO ALPE-ADRIA-BANK SPA, Udine, Italy	34	216
- HYPO ALPE-ADRIA-BANK d.d., Zagreb, Republic of Croatia	785	188
- HYPO ALPE-ADRIA-BANK d.d., Mostar	99	100
- HYPO ALPE-ADRIA-BANK a.d., Beograd , Serbia	220	-
Term deposits:		
- HYPO ALPE-ADRIA-BANK International AG, Klagenfurt, Austria	2,347	21,632
Other assets:		
- HYPO ALPE-ADRIA-BANK International AG, Klagenfurt, Austria	14	-
- Hypo Alpe-Adria-Leasing d.o.o. Banja Luka	12	-
- HYPO ALPE-ADRIA-BANK d.d., Zagreb, Republic of Croatia	4	-
- HYPO ALPE-ADRIA-BANK d.d., Mostar	311	60
- HYPO ALPE-ADRIA-BANK a.d., Podgorica, Montenegro	16	11
- HYPO ALPE-ADRIA-BANK a.d., Beograd, Serbia	12	7
	6,915	27,261
Liabilities:		
Demand deposits:		
- Hypo Alpe-Adria-Leasing d.o.o., Sarajevo	2	739
- HYPO ALPE-ADRIA-BANK International AG, Klagenfurt, Austria	795	204
- HYPO ALPE-ADRIA-BANK a.d., Podgorica, Montenegro	11	149
- HYPO ALPE-ADRIA-BANK a.d., Beograd, Serbia	1	-
- HYPO ALPE-ADRIA-BANK d.d., Zagreb, Republic of Croatia	91	91
- Hypo Alpe-Adria-Leasing d.o.o. Banja Luka	771	-
- HYPO ALPE-ADRIA-BANK AG, Klagenfurt, Austria	-	67
- Hypo Alpe-Adria-Immobilien-Beteiligungs GMBH, Austria	-	1
Short-term deposits:		
- HYPO ALPE-ADRIA-BANK International AG, Klagenfurt, Austria	27,337	-
Long-term deposits:		
- HYPO ALPE-ADRIA-BANK International AG, Klagenfurt, Austria	353,076	520,257
Subordinated liabilities:		
- HYPO ALPE-ADRIA-BANK International AG, Klagenfurt, Austria	35,470	35,470
Other liabilities:		
- HYPO ALPE-ADRIA-BANK International AG, Klagenfurt, Austria	11,978	177
- HYPO ALPE-ADRIA-BANK a.d., Beograd, Serbia	224	158
- HYPO ALPE-ADRIA-BANK d.d.,Mostar	338	116
- HYPO ALPE-ADRIA-BANK d.d., Zagreb, Republic of Croatia	49	77
- ZIS Beograd, Serbia	8	7
- Hypo Alpe-Adria-Leasing d.o.o. Banja Luka	2	-
- Hypo Alpe-Adria- Leasing d.o.o., Sarajevo	2	-
- HYPO ALPE-ADRIA-BANK a.d., Podgorica, Montenegro	14	3
	430,169	557,516

30. Related Party Transactions (continued)

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Interest income:		
- HYPO ALPE-ADRIA-BANK International AG, Klagenfurt, Austria	53	37
- HYPO ALPE-ADRIA-BANK d.d., Mostar	-	6
- HYPO ALPE-ADRIA-BANK SPA, Udine, Italy	2	5
Fee and commission income:		
- HYPO ALPE-ADRIA-BANK d.d., Mostar	177	169
- HYPO ALPE-ADRIA-BANK AG, Klagenfurt, Austria	-	29
- HYPO ALPE-ADRIA-BANKSPA, Udine, Italy	8	13
- Hypo Alpe-Adria-Leasing d.o.o., Sarajevo	6	-
- HYPO ALPE-ADRIA-BANK International AG, Klagenfurt, Austria	31	2
Other operating income:		
- HYPO ALPE-ADRIA-BANK International AG,Klagenfurt, Austria	3	48
- HYPO ALPE-ADRIA-BANK d.d., Mostar	182	-
- Hypo Alpe-Adria-Leasing d.o.o. Banja Luka	19	-
- Hypo Alpe-Adria-Leasing d.o.o., Sarajevo	15	25
	496	334
Interest expenses:		
- HYPO ALPE-ADRIA-BANK International AG, Klagenfurt, Austria	(21,102)	(20,338)
- Hypo Alpe-Adria-Immobilien AG, Klagenfurt, Austria	-	(333)
- Hypo Alpe-Adria-Leasing d.o.o., Sarajevo	(2)	-
- Hypo Alpe-Adria-Leasing d.o.o. Banja Luka	(2)	-
Fee and commission expenses:		
- HYPO ALPE-ADRIA-BANK International AG, Klagenfurt, Austria	(2,448)	(2,347)
- HYPO ALPE-ADRIA-BANK d.d., Mostar	(90)	(88)
- HYPO ALPE-ADRIA-BANK, d.d Zagreb, Republic of Croatia	(27)	(28)
- HYPO ALPE-ADRIA-BANK SPA, Udine, Italy	(9)	(1)
- HYPO ALPE-ADRIA-BANK d.d.,Ljubljana, Republic of Slovenia	-	(1)
- HYPO ALPE-ADRIA-BANK a.d., Beograd, Serbia	(3)	-
- HYPO ALPE-ADRIA-BANK AG, Klagenfurt, Austria	-	(1)
Other operating expenses:		
- HYPO ALPE-ADRIA-BANK International AG, Klagenfurt, Austria	(1,542)	(951)
- ZIS Beograd, Serbia	(3,012)	(784)
- HYPO ALPE-ADRIA-BANK d.d., Zagreb, Republic of Croatia	(632)	(523)
- HYPO ALPE-ADRIA-BANK, Mostar	(338)	-
	(29,207)	(25,395)
Net expenses	(28,711)	(25,061)

The Bank received significant funding from its parent company in the form of demand deposits, short-term deposits, long term deposits and subordinated debt representing 26.89% of its total sources of funding (2010: 36.68%).

30. Related Party Transactions (continued)

Management Remunerations

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Net salaries	237	287
Taxes and contributions	156	161
	393	448

31. Effects of the Financial Crisis

Current Instability in the Global and market of Bosnia and Herzegovina

The ongoing global liquidity crisis, which commenced in the middle of 2007 and escalated mid-2008, has resulted in, among other things, a lower level of capital market funding, lower liquidity levels across the banking sector, and, at times, higher interbank lending rates and very high volatility in stock markets. The uncertainties in the global financial markets have also led to bank failures and bank rescues in the United States of America, Western Europe, Russia and elsewhere. Indeed the full extent of the impact of the ongoing economic crisis is proving to be impossible to anticipate or completely guard against.

Contemporary events may have broader effects globally, given that this time the main feature of recession is government debt and not consumer debt, as was the case in 2008.

On the other hand, financial institutions all over Europe, have large amounts of receivables in the form of government and corporate bonds in Portugal, Italy, Greece, Ireland and Spain. The fear of "epidemic" has been augmented by the fact that European banks perform daily transactions worth billions with their American partners, as there both positive and negative globalization aspects. Segments are all interconnected with one another resembling the joined vessel system. Negative aspects from one end or segment, are reflected onto another as well. The consequences depend on the global market exposure of an individual country. This is precisely to what extent the crisis has had and will continue to have impact on Bosnia and Herzegovina (BiH).

The effects of the crisis may be indirect as BiH is not exposed to within global capital market. Firstly, such effects may reflect to stock exchange volatility of prices of major export goods - alkali metals (aluminum, steel, etc.). Secondly, decrease in or cessation of money transfers from abroad is possible if the new wave of crisis affects the countries wherefrom money is transferred to BiH. In addition, the banking sector will unavoidably suffer the consequences in case the crisis affects parent banks exposed in the global market with affiliates in BiH. However, the most recent data for the third trimester of 2011 show increase in money transfers from abroad whereof 40% refers to foreign pensions that are guaranteed.

In addition, In November 2011, Standard & Poor's revised BiH outlook from positive to negative and lowered BiH's long-term sovereign credit rating by one grade and described it as highly speculative due to political instability. However, as the Government was constituted in February 2012 (the newly formed Council of Ministers of BiH), this means that the political blockage of BiH has finally ended 16 months following the election. We expect that the suspended projects will be "unfrozen" and economic activities stimulated.

We underline that the objective of the new Government of BiH is to fulfill all the requirements set forth by the European Union within ensuing months so that on June 30, 2012 BiH can apply for membership in the EU, which we expect will eventually happen

Management believes it is taking all the necessary measures to support the sustainability and growth of the Bank's business in the current circumstances, including the further deterioration of liquidity.

Impact on Liquidity

Throughout 2011 the liquidity of the Bank was stable. Foreign debt gradually decreased, while the local source of funding gradually increased. As on the other side there was no significant credit activity, the Bank's liquidity position was satisfactory during the year.

31. Effects of the Financial Crisis (continued)

Impact on Customers/Borrowers

Debtors or borrowers of the Bank may be affected by the lower liquidity situation which could in turn impact their ability to repay the amounts owed. Deteriorating operating conditions for customers or borrowers may also have an impact on the management's cash flow forecasts and assessment of impairment of financial and non-financial assets. However, implementation of a new loan process has had a significant impact on limiting and monitoring existing risks. By improving the loan process, impact on customers/ borrowers has been reduced to an optimized level, through the introduction of new standards related to client assessment.

To the extent that information is available, the management has properly reflected revised estimates of expected future cash flows in their impairment assessments. The structure of Bank sources provides sufficient reserves for significant restructuring/ prolongation of the existing exposures towards clients.

Impact on Collaterals (especially real estate)

The amount of provisions for impaired loans is based on management's estimate as of the balance sheet date after taking into consideration cash flows that may result from foreclosure of collateral, decreased for costs of obtaining and selling the collateral. The local market for many types of collateral, especially real estate, has been severely affected by the recent volatility in global financial markets resulting in a lower level of liquidity and market value of property. The Bank performs a periodical evaluation of collaterals, in order to ensure that provisions are accurately estimated.

Fair Value of Financial Assets and Liabilities (excluding financial assets and liabilities directly related to the credit crisis, for example mortgage used as a guarantee)

Fair value of quoted investments in active markets is based on current bid prices (financial assets) or offer prices (financial liabilities). If there is no active market for a financial instrument, the Bank establishes fair value using different valuation techniques. These include the use of recent arm's length transactions between willing parties, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. The valuation models reflect current market conditions at the measurement date which may not be representative of market conditions either before or after the measurement date. As of the balance sheet date, management has reviewed its models to ensure they appropriately reflect current market conditions, including the relative liquidity of the market and credit spreads.

Valuation of investment property at fair value

Many types of real estate have been severely affected by the recent volatility in both global and local financial markets.

Fair value of land and buildings measured at revaluated amounts in accordance with IAS 16 has been updated to reflect market conditions at sufficient frequency to ensure that the carrying value does not differ significantly from the fair value at the end of reporting period.

In accordance with IAS 40, fair value of investment property is the price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction. A 'willing seller' is not a forced seller prepared to sell at any price, nor someone who is ready to wait for the price that is not reasonable under the given market conditions. The best evidence of fair value is given by current prices in an active market for similar property in the same location and condition.

If, in exceptional cases, there is clear evidence that when the Bank first acquires an investment property (or when an existing property first becomes investment property following the completion of construction or development, or after a change in use) the fair value of the investment property is not reliably determinable on a continuous basis, then the Bank measures that investment property using the cost model in accordance with IAS 16.

The cost of an item of property, plant and equipment comprises:

- its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

31. Effects of the Financial Crisis (continued)

- the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Examples of directly attributable costs are:
- costs of employee benefits (as defined in IAS 19 Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;
- costs of site preparation;
- initial delivery and handling costs;
- installation and assembly costs;
- costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
- professional fees.

32. Operating Lease

Operating lease expenses in the fiscal year 2011 totaled BAM 690 thousand (2010: BAM 640 thousand).
Total future minimum lease payments pursuant to the long-term contractual lease are presented in the following table:

	In thousands of BAM	
	December 31, 2011	December 31, 2010
Up to 1 year	628	654
From 1 to 5 years	1,619	1,506
Over 5 years	216	428
	2,463	2,588

33. Taxation Risks

The Republic of Srpska and Bosnia and Herzegovina currently have several tax laws in effect, as imposed by various governmental agencies. The applicable taxes include: a turnover tax, corporate tax, and payroll (social) taxes, among others. Following their introduction, the regulations governing these taxes were not enforced for substantial periods of time; in contrast to similar legislation in more developed market economies. Moreover, the regulations defining the implementation of these laws are often unclear or non-existent. Hence, few precedents with regard to tax issues have been established in the Republic of Srpska. Often, contrary opinions pertaining to legal interpretations exist both among, and within, governmental ministries and organizations, thus creating uncertainties and areas of legal contention. Tax declarations, together with other legal compliance matters (e.g., customs and currency control matters) are subject to the review and investigation by a number of authorities that are legally enabled to impose extremely severe fines, penalties and interest charges.

The interpretation of tax legislation by tax authorities as applied to the transactions and activity of the Bank may not coincide with that of the management. As a result, transactions may be challenged by tax authorities and the Bank may be assessed additional taxes, penalties and interest, which can be significant. In accordance with the Law on Tax Authority of the Republic of Srpska, expiration period of the tax liability is five years. This practically means that tax authorities could determine payment of outstanding liabilities in the period of five years from the origination of the liability. The afore-described

33. Taxation Risks (continued)

situation creates tax risks in the Republic of Srpska that are substantially more significant than those typically existing in countries with more developed tax systems.

In order to minimize taxation risk, the Bank at times hires taxation experts to aid the bank in interpreting and implementing tax regulations. With regard to the PTA Agreement, during 2011 and early in 2012, the Bank relied on the services of taxation experts and contacted tax authorities on several occasions (Indirect Taxation Authority of Bosnia and Herzegovina) in order to obtain legally compliant opinions on the taxation treatment of the PTA, entered into by the Transferor of cash flows, Transferee and Calculation Agent. The Bank had not obtained any legally compliant opinion on the taxation treatment of the aforesaid agreement until the date of issuance of the accompanying financial statements. In addition to the aforesaid, the Bank holds that PTA is tax-neutral and not subject to value added taxation so that it will not have adverse effects on the Bank.

34. Exchange Rates

The official exchange rates for major currencies as of December 31, 2011 and 2010 used in the translation of balance sheet components denominated in foreign currencies into BAM were as follows:

	In BAM	
	December 31, 2011	December 31, 2010
USD	1.5116	1.4728
CHF	1.6089	1.5678
EUR	1.9558	1.9558

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