# AS LHV Group
# Consolidated Annual Report 2018

(Translation of the Estonian original)

**Consolidated Annual Report 01.01.2018 – 31.12.2018**

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|---|---|
| Legal name | **AS LHV Group** |
| Commercial Registry no. | **11098261** |
| Legal address | **Tartu mnt 2, 10145 Tallinn** |
| Phone | **(372) 6800400** |
| Fax | **(372) 6800410** |
| E-mail | **lhv@lhv.ee** |
| Main activities | **Activities of holding companies**<br>**Banking**<br>**Security brokerage**<br>**Financial advisory**<br>**Finance lease and other lending** |
| Management Board | **Madis Toomsalu** |
| Supervisory Board | **Rain Lõhmus**<br>**Andres Viisemann**<br>**Tiina Mõis**<br>**Heldur Meerits**<br>**Raivo Hein**<br>**Tauno Tats**<br>**Sten Tamkivi** |
| Shares | **Listed on the Nasdaq Tallinn Stock Exchange** |
| Auditor | **AS PricewaterhouseCoopers** |

**Table of contents**

# Statement of Managing Director

Dear LHV investor,

LHV has had a strong, industrious year. A year characterised by good results, a strong growth in customer base, various new products and recognitions. At the beginning of July, LHV was declared the best Estonian bank by the international Euromoney magazine. This was a follow-up to the title of the best private banking service provider, awarded to LHV by Euromoney at the beginning of the year.

The recognition, as well as the achievements described below, must be attributed to the 380 staff members of LHV. Our employees are making a daily effort to further enhance the position of LHV as an Estonian capital-based company in the local financial services market, while also contributing to LHV's success as an exporter of financial services. We take pride in our supportive working environment, as evidenced by the highest ever results of the end-of-year employee satisfaction survey.

LHV posted record-breaking results in all business areas in 2018. LHV Bank's customer numbers grew by 28 thousand, and the volume of loans by EUR 199 million to EUR 919 million. Even though the total volume of deposits of LHV Bank decreased by EUR 99 million, the volume of standard customer deposits grew by EUR 314 million, if we do not include the planned reduction in the volume of deposits of financial intermediaries. Pension funds grew by EUR 115 million, amounting to EUR 1,204 million as at the end of the year. We also achieved record levels of customer activity in payments, card transactions and conclusion of new investment agreements.

LHV's net profit amounted to EUR 27.2 million in 2018. This constitutes a EUR 5.0 million increase from last year, generating a 19.3% return on equity before taxes and an 19.0% return on equity on net profit basis for the shareholders of LHV. We exceeded our financial forecasts by EUR 1.1 million. Profit was supported by customer activity and revenue from capital market transaction consulting. Business volumes and profits increased in all core business areas.

Corporate banking witnessed a one-third growth in business loans. Our loan stock has shown the swiftest growth on the market. We are able to make progressively better offers for large loan amounts. The economic environment has remained favourable, but we continue monitoring domestic and external economic developments affecting Estonian enterprises. More than in previous periods, corporate banking results were affected by write-downs associated with a single customer. Nonetheless, this is no characterisation of the surrounding business environment and cannot be deemed an indication of our loan portfolio, which continues to stand strong.

To enhance corporate banking offers, we started to contribute trade-financing products at the beginning of the year. Above all, mention must be made of factoring. Our pursuit of growth in business volumes requires a credit rating. At the end of the year, Moody's gave LHV Bank a credit rating of Baa1. A credit rating will ensure the acceptability of the guarantees provided by LHV Bank to guarantee beneficiaries beyond Estonian borders. We also concluded a EUR 20 million agreement with the Nordic Investment Bank, aiming to improve the credit capacity of small and medium-sized enterprises.

In retail banking, we focused on housing loans, enhancement of investment services and development of customer-oriented services. As a major innovation, we implemented the e-identification system, which allows customers to open a bank account via internet bank, without leaving the comfort of their home. We also expanded LHV's ATM network, which now includes 21 ATMs all over Estonia. We will continue installing new ATMs in 2019.

In our housing loan offers, we focused on big-city customers who value a smooth, swift and collaborative service. The housing loan portfolio grew by EUR 61 million, amounting to EUR 139 million as at the end of the year. We offer housing loans at a price, which serves to secure the return on equity promised to the shareholders.

At the end of August, we launched the Youth Bank offer, providing a specially designed youth card, student loan and micro-investment service. Our micro-investment service targets all those, who wish to start investing without any previous knowledge in the field, favourably, with low-level regular contributions and a near-zero time cost. We contributed to the launch of mTasku (a new payment platform developed by Telia) and launched the health and home repair loan.

In the business area of financial institutions, we focused on searching new customers and expanding the product portfolio. There is great interest in flexible banking services among financial institutions, with new customers constantly joining up. Nonetheless, the process of becoming a customer takes time - on the one hand, financial institutions must often complete a time-consuming licence application procedure; on the other hand, we pay special attention to AML and KYC principles. Our business in United Kingdom is profitable, with revenue generated from payments, currency exchange, card payment mediation, credit services and maintenance fees.

The total volume of investment funds managed by LHV Asset Management exceeded EUR 1.2 billion in 2018. A bulk of the fund volume is composed of actively managed pension funds, where LHV's investment strategy clearly differs from that of competing pension funds.

2018 was a difficult year for investors, with only a few markets generating a positive yield. European shares lost 10.6% and developing markets 10.3% of their value. LHV has previously decided to direct pension investments in alternative asset categories and the local market. This choice can be attributed to the elongated rise in international securities markets, which LHV Asset Management deems too expensive to invest in. The chosen strategy helped LHV to maintain the assets of the actively managed funds in 2018, with the corresponding yield falling between -0.1% and 1.1%. These yields are among the highest in actively managed funds on the market.

The amendment of the Investment Funds Act in December 2018 will have a significant effect on the fee structure of pension funds. Fixed fees will be significantly lowered, while providing the option of earning a performance bonus. At the same time, investment restrictions will be significantly eased, allowing funds access to a wider range of investment strategies. A majority of the amendments will enter into force in September 2019.

Other highlights of the year included the first publication of LHV's five-year financial forecast in February 2018, alongside the annual financial plan. The financial plan was corrected in May, with profit targets raised. We succeeded in achieving our objectives, and exceeded the planned profit by EUR 1.1 million.

In May, we disposed the Lithuanian consumer credit company UAB Mokilizingas. The value of the shares held by LHV amounted to EUR 7.5 million, with a total of approximately EUR 3 million earned in profit from the transaction.

The issue of LHV Group's subordinated bonds was carried out at the end of the year. There was great interest in the bonds, with the issue volume thus raised to EUR 20 million. The subscription volume was the highest ever among our capital engagements. A total of 1,700 investors subscribed to LHV's bonds in the total amount of more than EUR 51 million. The bonds formed a part of our EUR 45 million bond programme aimed at securing LHV's growth targets.

**Business environment**

Our greatest concern with respect to the long-term economic outlook lies in the difference in the dynamics of different European regions, as well as over-regulation, which adds to stagnation. There is no reward without risk – it is the core principle of market economy. The ever-increasing tendency to avoid risk and produce red tape is bound to hamper potential development and curb revenues. Our concerns are further fuelled by the fact that Europe is falling behind, compared to United States and China.

In the short-term perspective, however, the base scenario still revolves around an annual economic growth of a few percentages in the euro area. LHV's trends of growth are also supported by the Estonian economic environment. The Estonian economy has shown good growth, with domestic risks mitigated by the balanced state budget, low public sector debt and positive external balance.

We are waiting for the economy to slowly gain momentum. Nonetheless, it is becoming increasingly difficult to make any forecasts with regard to the surrounding economies. The trench tactics used in the trade wars, the ever-increasing volatility in the stock markets and the rise in the risk premiums of the sovereign bonds of developing markets are a cause for concern. The greatest problem with Europe lies in its failure to raise interest rates before the potential economic cooling, and to carry out the reforms required for improving the long-term outlook of weaker markets. With the Estonian economy being wide open to changes in the external environment, these trends will have a direct impact. Domestic risks include the tensions brewing on the labour market, albeit these can be alleviated by economic cooling, as well as the unstable tax environment and growing risks in the construction and trade sector.

The money laundering scandals involving some of the market participants have cast shadow on the financial sector in 2018. The isolation of the incident and its limitation to only a few market players is evident in the Basel Institute's money laundering risk table, where Estonia ranks second. Nonetheless, Estonia has suffered reputation damage. This is bound to complicate access to financing for the financial sector, scale down the interest of correspondent banks and affect potential credit ratings.

Against such backdrop, the credit market, nonetheless, stands strong. All major credit products, including corporate loans and housing loans, are increasing. The financial health of households remains strong, with the loan-to-deposit ratio improving. The share of overdue loans has dropped below 1%, largely covered by write-downs.

**Strategy and the future**

LHV has built its strategy around Estonia as the domestic market, where LHV will focus on providing the best banking services and the best yield for pension funds. We wish to reach out to a growing number of customers, who value the importance of Estonian capital in the provision of local financial services. We will conduct our business in a manner, which ensures that the ever-increasing efficiency would be manifested in a lower cost-income ratio and that the shareholder would be provided with a 20% return on equity before taxes. Alongside Estonia, we will also search for new business opportunities on foreign markets, and have become an exporter of financial services. We have had a strong start in United Kingdom, where our business is now profitable.

As regards private customers, we will focus on expanding the customer base and enhancing customer activity. Our focus lies on major Estonian cities, targeting active customers who prioritise electronic channels. We make an effort to attract young people as customers of LHV. We are laying greater emphasis on customer activity. We wish to engage customers who have opened a current account in LHV, whose salary is transferred to the LHV account and who uses the LHV bank card for his or her daily financial affairs. In the area of payments, we will start offering instant payments in euros. In the area of credit products, we will focus on swift decision-making. In the area of investment products, we are making an effort to enhance the visibility of our products and will only issue housing loans on conditions securing an excellent cost-income ratio and the desired return on equity for the shareholders.

As regards corporate customers, we will focus on boosting the loan portfolio and the share of trade financing. We will focus on customers in search of a bank that understands the nature of their business and is able to provide the required financing structure. We will continue the single-level decision-making process, where all decisions are made locally, swiftly and in a flexible manner.

In the area of financial institutions, we will continue to add to the product portfolio. We will join the real-time GBP payment system, making LHV one of the first banks in the world to provide both EUR and GBP payments in real time. We will continue providing account services, payments, card payment acceptance, loans and currency exchange services. We will expand our customer base by continuing to offer tailor-made solutions. Even though our office is located in London, the business of financial institutions often has a cross-border nature. We will therefore also seek out customers in other European capitals.

As regards pension funds, our priority is to generate the best yield for the pension fund customer. We are currently in the process of changing our investment strategy, focusing more on over-the-counter private investments.

On a more practical scale, we have established our goals for the next few years as follows. We endeavour:

- to serve as the best financial service provider to private customers and SMEs who wish to save and invest financial assets;
- to be the most collaborative financial service provider for international financial institutions;
- to serve as an attractive and recognised employer, offering progress, self-fulfilment and growth;
- to do business in such a way as to ensure a 20% return on equity;
- to become Estonia's most valuable publicly traded company.

LHV has more than 5,600 shareholders as at the end of the year, with more than 4,800 keeping their LHV shares in LHV Bank. All shareholders have the possibility to contribute to the rise in LHV's value by actively using LHV's services. It would be an honour, if also the remaining 800 shareholders kept their shares in LHV Bank.

Madis Toomsalu

# Business environment

According to the forecast published by the Organisation for Economic Co-operation and Development in November 2018, global economic growth will decelerate to 3.5% in 2019 and 2020. The upturn of trading, which has so far supported the recovery, has stopped and the global purchasing managers' index (PMI), which recognises the evaluation of the operating environment of the companies, is decreasing. The plunge of the oil price which began towards the end of 2018, is negatively affecting countries dependant on the export of the commodity, providing relief for the importers affected by the appreciation of the US dollar. The situation continues to improve on the labour market and the pace of wage growth is finally rising. Economic growth is less balanced compared to recent years – there are clearly major economies distinguishing, where the upward cycle has already peaked.

The values of increased assets illustrate the current expansive monetary policy, in which the investors have accepted an increasingly lower expected long-term rate of return. The central banks of developed countries led by the US are changing course, as a result of which there are new signs of a turning liquidity offer. The volatility of stock markets has significantly increased, as well as the differences in the interest rates of bonds with varying degrees of risk. The currencies of developing countries are under pressure. Risks with a negative impact on the global economy, led by a protectionist economic policy, have increased. Altogether, we may expect a slowdown of economic growth in the developed countries during the next year close to the long-term sustainable level, which is clearly lower compared to the decade preceding the financial crisis.

Eurozone economic growth decelerated in the second quarter to 2.1%. The economic growth based on domestic demand was broad-based, however we can still spot some weakness in export over recent quarters. The growth of industrial production has entangled compared to the beginning of the year, the problems in the automotive industry have had a negative impact. A decline of sentiment may be noticed in indicators that reflect the confidence of various sectors. The big picture of the economy is still good and the growth positive regarding all countries. The economies of Finland and Sweden, the countries that are independently the biggest export targets for Estonia, grew 2.4% and 1.6% in the third quarter respectively. This year, the deceleration of Finnish economic growth is expected which is mainly due to the decrease of external demand. The growth rate of import will, on the contrary, remain basically at the same level as the previous year, which is still in favour of Estonian trade. The economic and import growth of Sweden is also decelerating but remains favourable to Estonia. Riksbank (the central bank of Sweden) has also taken a direction towards the increase of interest rates, which cools the economy but could have a positive effect on Estonian exporters through the appreciated Swedish krona.

The growth of the Eurozone's consumer prices has remained, for more than six months, at the level of 2.0% set by the European Central Bank, even though the core inflation is the lowest. According to the current plan, the exit from the current expansive monetary policy will be extremely slow – the bond purchasing programme was terminated in December 2018 and the interest rates shall not be increased before autumn of next year. According to the consensus expectations, the economic growth of the Eurozone shall drop to 1.9% in 2019. Since there are various headwinds blowing from export markets, the role of domestic demand and private consumption will become even more important. Consuming is supported positively by an increase in the labour force participation rate and the continuing decrease in the unemployment rate, which is also speeding up wage growth. At the same time, a looser budget policy is expected from the governments. Risks inside and outside the union have increased – the impact of the normalisation of monetary policy on stock and bond markets, the protective economic policy of the USA, the uncertainty accompanying the current Brexit process, increasing discontent and the populism in Italy and France. Next spring we will see the European Parliament elections, which will add even more tension.

Estonian economic growth accelerated in the third quarter of 2018 to 4.2%. The result was rather exceptional in the big picture since the indicators characterising the growth of economic activity weakened during the same period in Estonia and elsewhere. However, the economic picture was not as strong on a broad basis any more. Export growth decelerated significantly and the growth was led by domestic demand. As for the areas of activity, the growth was relatively uneven – almost half of the economic growth came from the construction and real estate sector. From the positive side, the investments showed signs of recovery, led by the investments of companies which is important for maintaining competitiveness. The inflationary pressure, which affects consumers negatively, is one of the highest of the Eurozone.

The bigger picture still remains good, which is also confirmed by the new outlook of the economic environment published by the Estonian Institute of Economic

Research in October 2018. Estonian experts assess the economic climate to be good and outlook stable. The Economic Sentiment Index has slightly declined, however it remains higher compared to the long-term average. The picture is also strong by sectors, with only the service sector having a more negative attitude compared to the long-term average. Lack of skilled labour, but also little innovation and decreasing international competitiveness are pointed out as the main factors obstructing business. Private consumption is strong, supported by high confidence and the improved financial situation of families.

According to the forecast published by the Bank of Estonia, the economic growth of Estonia will decelerate to 3.2% in 2019. Further rapid economic growth is hindered by the high conjuncture related supply-side restrictions (lack of available resources) but also the deceleration of external demand. The main growth engine is domestic demand, led by private consumption and investments. Private consumption is still supported by the strong growth of salary and employment. In addition, the inflation rate should marginally decrease, which is aided by the stabilisation of energy prices and the major impact of tax increases remaining in the earlier years. The positive contribution of investments is also restored, which was negatively influenced by a high comparison base last year. The volume of research and development activity is growing fast and capital investment into products related to the right of use of intellectual property is becoming increasingly important. From the risks, we could consider the most important to be developments in the external environment, which could be negatively influenced above all by declined demand caused by trade restrictions and the related insecurity when making investments and the impacts related to the tightening of monetary policy. Within Estonia, it is primarily necessary to deal with the improvement of competitiveness and favour the re-learning of employees and the movement to sectors offering higher added value. There are still a lot of industries with low production in Estonia which will most likely disappear with the continual increase of employment expenses in the next few years.

Over the next twelve months, LHV is expecting a continuation of positive trends in the Estonian economy. Economic growth will decelerate close to the long-term sustainable potential level. The shortage in available resources will continue to increase the significance of the ability of businesses to adapt and be successful in raising productivity, which is why it is necessary to vigorously continue making additional investments. First and foremost, it is important to achieve long-term sustainable economic growth that is in balance between the various sectors.

In terms of economic sectors, the risks are above average and might overheat in the building sector, accommodation and catering sector, and transport and storage. LHV is still conservative with regard to the housing market, monitoring the local and Scandinavian market, with increased attention on developments in Sweden. Regarding rental cash flow projects, there is a risk that there will not be enough demand to absorb the volumes being developed in the near future, so that corrections will take place in rental prices or vacancy rates.

As a positive note, we could highlight the still favourable financing environment, which will be influenced most in the coming years by the tightening monetary policy of developed countries. The increase of the amount outstanding from credit institutions still remains rapid. The demand for loans of households is strong, led by housing loans and car leasing. For new housing loans, the average interest rate which has started to increase is standing out. Due to poor investment activity and relatively high own funds, the loans taken by corporates are more modest than that of households. The ratio of loans to deposits and the proportion of overdue loans in the loan portfolio are at the post-crisis low levels. Historically low interest rates and strong competition between banks offer possibilities to local enterprises and they should be taking advantage of them more. LHV wishes to make a big and effective contribution to the finding and supporting of new growth sources, offering entrepreneurs long-term co-operation and value-creating involved thinking.

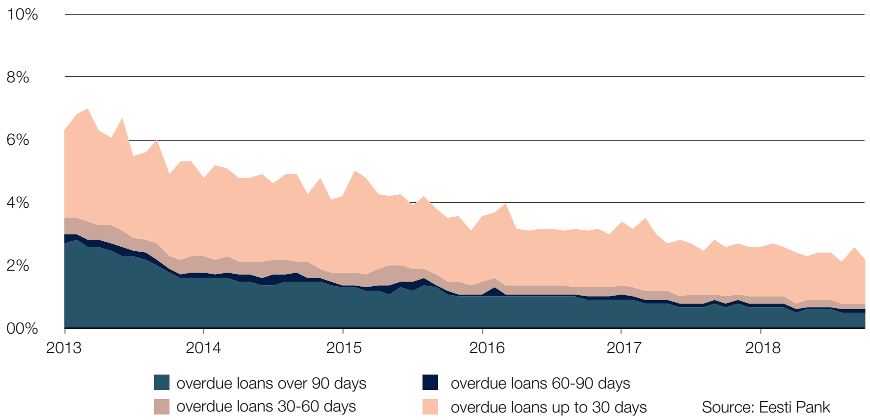
**Key economic indicators of Estonia***

| | 2013 | 2014 | 2015 | 2016 | 2017 | Eesti Pank forecast 2018E | 2019E | 2020E |
|---|---|---|---|---|---|---|---|---|
| Nominal GDP (EUR billion) | 18.89 | 19.76 | 20.25 | 21.10 | 23.62 | 25.62 | 27.38 | 28.89 |
| GDP volume** | 1.4% | 2.8% | 1.4% | 2.1% | 4.9% | 3.6% | 3.2% | 2.3% |
| Private consumption expenditures*** | 3.8% | 3.3% | 4.7% | 4.4% | 2.6% | 4.3% | 3.9% | 3.2% |
| Government consumption expenditures | 1.9% | 2.7% | 3.4% | 1.9% | 0.6% | -0.5% | 1.2% | 0.3% |
| Fixed capital formation | -2.8% | -8.1% | -3.3% | -1.2% | 12.5% | 1.3% | 5.3% | 3.2% |
| Exports | 2.3% | 3.1% | -0.6% | 4.1% | 3.5% | 1.5% | 1.8% | 3.5% |
| Imports | 3.2% | 2.2% | -1.4% | 5.3% | 3.6% | 6.1% | 3.9% | 3.6% |
| CPI | 2.8% | -0.1% | -0.5% | 0.1% | 3.4% | 3.5% | 2.6% | 2.1% |
| Unemployment rate (% of the labour force) | 8.6% | 7.4% | 6.2% | 6.8% | 5.8% | 5.8% | 6.7% | 6.9% |
| Current account (% of GDP) | -0.4% | 0.9% | 2.2% | 1.9% | 3.3% | 0.5% | -1.0% | -1.0% |
| Budget balance (% of GDP)**** | -0.2% | 0.7% | 0.1% | -0.3% | -0.4% | 0.5% | 0.5% | 0.3% |

"* Numbers reported are annual rates of change in per cent, if not noted otherwise; ** GDP and its components are chain-linked; *** including NPISH; **** the budget balance forecast considers only those measures on which sufficient information was availanble at the date of the forecast.

Sources: Eesti Pank, Statistics Estonia"

**Overdue loans share in loan portfolio**

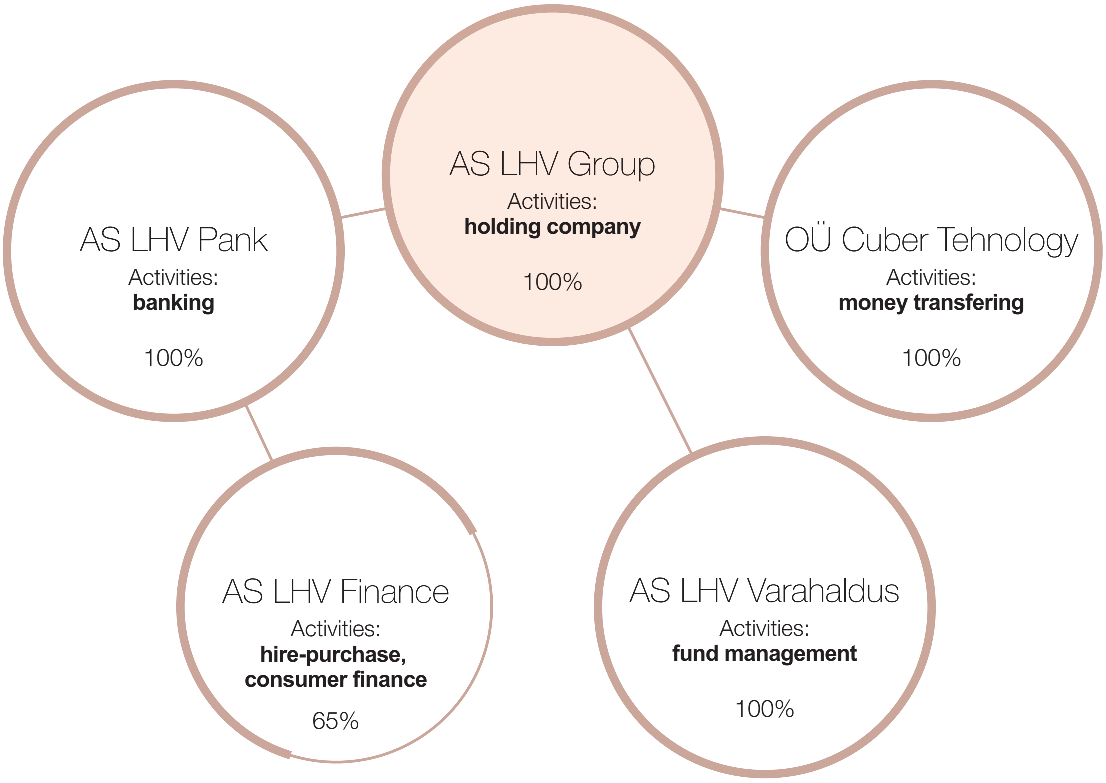



Source: Eesti Pank

# Management report

AS LHV Group (hereinafter: the Group or LHV) is the biggest domestic finance group and capital provider in Estonia. The main subsidiaries of AS LHV Group are AS LHV Pank (hereinafter: the Bank) and AS LHV Varahaldus (hereinafter: LHV Varahaldus). LHV was established in 1999 by people with long experience in investing and entrepreneurship.

LHV-s offices for client servicing are located in Tallinn and Tartu, also London office was opened in 2018. Over 370 people work in LHV. Over 192 000 customers use banking services offered by LHV and the LHV's pension funds have over 201 000 clients.




**Operating principles**

The mission of LHV is to help create local capital and to support the development of local entrepreneurship.

LHV concentrates on active and independent customers with an entrepreneurial mind-set. For private consumers LHV offers high quality universal banking services. For corporate clients LHV offers flexible and suitable financing and managing of everyday financial operations.

The products and services provided by LHV are simple, transparent and appropriate. Client interaction is mainly conducted using modern electronic communication channels. Costs avoided will reach the clients of LHV through affordable cost of everyday service.

LHV was created as a partnership and partnership is the central way of growing LHV's business. New initiatives will be implemented faster and more successfully when partners have same interests and long-term support of each other.

LHV is public company, which is listed on the Tallinn Stock Exchange since May 2016, so all clients and partners of LHV may be owners of LHV.

**Key events in 2018:**

- **LHV Bank**

Moody's Investors Service gave the bank an investment grade rating of Baa1, with a stable outlook.

- **LHV Varahaldus**

LHV Varahaldus started a new pension fund, which invests purely into Estonia – LHV Pensionifond Eesti.

- **Disposal of UAB Mokilizingas**

In May LHV sold its 50% ownership in UAB Mokilizingas receiving EUR 2.9 million extraordinary profit.

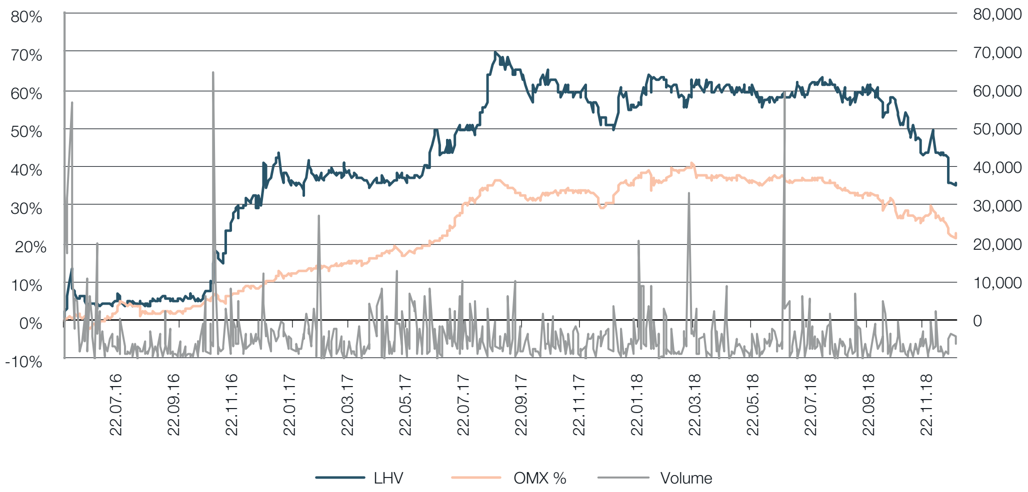
### Shares and bonds issued by LHV

Over the last years LHV has been capitalized, being a rapidly growing local retail bank with clear niche towards financial intermediates. The profits and investments of LHV are not only contributable to the share price, but also part of the dividends and interest paid to subordinated bonds. LHV has several securities outstanding:

| Name | ISIN | Issuer | Outstanding amount | Maturity | Listing |
|---|---|---|---|---|---|
| Common share | EE3100073644 | AS LHV Group | 26 016 485 | - | Nasdaq Tallinn main list |
| Subordinated bond | EE3300110741 | AS LHV Group | 15 000 000 | 29/10/2025 | Nasdaq Baltic bond list |
| Subordinated bond | EE3300110550 | AS LHV Group | 15 900 000 | 20/06/2024 | Nasdaq Baltic bond list |
| Subordinated bond | EE3300111558 | AS LHV Group | 20 000 000 | 28/11/2028 | Nasdaq Baltic bond list |

There is only one class of shares issued by LHV, each share gives 1 voting right. The shares of LHV Group is traded on NASDAQ Tallinn main list since May 2016. Since then, the share price has risen by 34%, reaching EUR 9.4 by the end of 2018. In 2018, the lowest traded price was 9.2 euros and the highest 11.4 euros. Based on the stock price, LHV's market value was EUR 245 million. In respect of dividend policy, LHV strives to achieve long-term dividend growth without negatively impacting the group's targeted capital ratios. The annual dividend together with dividend related taxes shall correspond to 25 per cent of pre-tax profit. Each year's dividend is assessed in the light of prevailing economic conditions and the Group's earnings, growth possibilities, regulatory requirements and capital position. In addition, LHV has made a conservative decision not to have trading positions in LHV shares nor take them as collateral. In case of exercising share option programs, the shareholders have delegated the right of issuing new shares to the Supervisory Board.

**LHV share price development**




During 2018, 1.0 million shares in the amount of EUR 11.16 million changed the owner on the stock exchange, which makes 11.2 euros for the average trading price.

At the end of 2018, LHV Group had 5 615 shareholders, of whom 86.2% were also customers of LHV Bank. They were followed by Swedbank customers (9.6%) and SEB customers (3.8%). 74.9% of the shares belonged to enterprises and 25.1% to private individuals. Among the shareholders, the Estonian residents or their related companies, who own 99.9% of the shares, are clearly dominant.

LHV has had three subordinated debt issues on Nasdaq Tallinn Stock Exchange. The maturity of the first bond is in 2024, the second in 2025 and latest bond issued in November 2018 with maturity in 2028. The new bond issued is to strengthen the LHV Group capitalization and allows with prior acceptance from Estonian FSA potential buy-back of 2024 bonds in June 2019. Bond trading in Nasdaq Baltics bond list is very limited, as most of investors have "invest and keep" strategy. The total turnover in 2018 was EUR 1.78 million.

At the end of the year 2018, LHV Group had almost 1 000 bondholders, 70% of them were also customers of LHV Pank. They were followed by the customers of Swedbank at 15% and SEB at 11%. Of the investor base, 68% were companies and 32% were private individuals. 99.8% of bond investors were Estonian residents or their related companies.

AS LHV Group has 26 016 485 common shares with par value of 1 euro. As at 31.12.2018, the distribution of shares was as follows:

- 13 104 054 shares (50.4%) belonged to the members of the Supervisory Board and Management Board and to their related parties.
- 12 912 431 shares (49.6%) belonged to Estonian entrepreneurs and investors and to their related parties.

**Ten biggest shareholders as at 31.12.2018:**

| Number of shares | Percentage | Name of the shareholder |
|---|---|---|
| 3 357 920 | 12.9% | AS Lõhmus Holdings |
| 2 538 367 | 9.8% | Rain Lõhmus |
| 2 111 344 | 8.1% | Viisemann Investments AG |
| 1 595 620 | 6.1% | Ambient Sound Investments OÜ |
| 1 210 215 | 4.7% | Krenno OÜ |
| 999 456 | 3.8% | AS Genteel |
| 951 978 | 3.7% | AS Amalfi |
| 722 297 | 2.8% | Kristobal OÜ |
| 636 260 | 2.5% | SIA Krugmans |
| 589 177 | 2.3% | Bonaares OÜ |

**Market share**

LHV has not set a specific target for market share, the goal is profitable growth combined with taking advantage of opportunities offered by the market. Every year, LHV has set the goal to grow faster than the market and thereby increase its market share. In terms of new clients, the goal is to increase the client portfolio that the growth would be higher than the number of children born each year. In recent years, we have almost doubled this target.

LHV market share differs in large scale between products: in pension products we have 27% market share and from another side only 1% market share in some newer products like mortgages, despite the fact that from new sales the market share in that is close to 10%. Based on Bank of Estonia calculation of systematically importance LHV scored 718 points equaling 7,18% of overall market share. We see that LHV is able to increase it’s market share to 8% in 2019.

**Remuneration policy**

The remuneration principles for LHV Group and its affiliated companies are described in the internal Remuneration Policy.

In LHV, there are no regional differences in the remuneration principles. The most significant difference between group companies is that LHV Varahaldus has no remuneration committee and has separate disclosure requirements.

The purpose of establishing remuneration principles within LHV is the organisation of fair, motivating and transparent remuneration in accordance with the law. A broader goal of the remuneration policy is the recruitment of employees with the capabilities, skills and experience necessary to implement the strategy, to reconcile the interests of employees and shareholders, to motivate the employees and to ensure effective risk management for growing business activities. The remuneration system consists of basic remuneration, compensations and employee benefits. LHV does not provide employees with services at a lower than the market price, does not make payments to a third pillar pension fund at the expense of the employer and does not provide benefits such as a company car, a mobile phone or a laptop for personal use.

The general remuneration strategy is to ensure a motivating pay to achieve long-term goals, creating a strong link between remuneration and the financial results of LHV. When measuring the key quantitative and qualitative results and assessing the risk, LHV shall be governed by the following principles:

- Performance criteria are in line with sound and effective risk management principles. The performance criteria established by LHV must keep in mind the long-term interests of LHV, including not stimulate excessive risk-taking or sale of unsuitable products.
- The performance criteria must not merely contain performance efficiency indicators (e.g. profit, revenue, profitability, expenditure and volume indicators) or market-based indicators (e.g. stock price or bond yield) but must also be adjusted with risk-based indicators (e.g. capital adequacy, liquidity).
- The criteria used for measuring risks and results shall be as closely related to the decisions of the staff member, whose results are being appraised, as possible, and should ensure that the process of the establishment of the remuneration would have an appropriate impact on the staff member’s profes-

sional behaviour. In the interest of long-term goals, the assessment and control of risk behaviour will take place at an individual employee level.

- A good balance of both quantitative and qualitative as well as absolute and relative criteria shall be used in the specification of the performance criteria.
- Quantitative criteria shall cover a sufficient period of time, so as to consider the risks taken by the staff members or business units. The criteria shall be risk-adjusted and contain economic efficiency indicators.
- Examples of qualitative criteria include achievement of strategic objectives, customer satisfaction, adherence to the risk management policy, adherence to internal or external rules of procedure, management skills, creativity, motivation and co-operation with other business units and the internal control function.

LHV's recruitment strategy is to find, engage and keep the best people of the labour market. In determining remuneration, LHV is rather willing to make exceptions than restrict its choices with strict remuneration intervals for a specific position. To keep its employees, LHV will develop its benefits and compensations in cooperation with its employees. In determining remuneration, the following is taken into account:

- Commitment and results of the employee,
- Workload,
- Responsibility,
- The required level of education,
- Management level,
- Intensity of work,
- The necessary knowledge and experience for the position,
- The existence of additional benefits,
- The situation in the labour market,
- The pay level of the geographical location,
- The level of criticality of the position

The determination of the amount of remuneration must be objective. The remuneration is paid according to the work done and its value, not according to the personality, gender, age, origin, etc. of the employee.

LHV applies a general principle that employees should not use personal hedging strategies or remuneration and liability insurance, which would undermine the effectiveness of the hedging of risks integrated into the Remuneration Policy. In the decisions made on remuneration policy, the financial situation and sustainability of the capital base of LHV are taken into account.

LHV carries out regular self-assessment, the purpose of which is to identify all employees whose professional activities affect or may affect the risk profile of LHV significantly. These specified groups of employees are listed in the table below together with ratios between variable and basic remuneration in 2018.

| **Specified group of employees** | **Ratio in 2018** |
|---|---|
| Senior management | 0.91 |
| Staff performing control functions | 0.24 |
| Employees with significant impact on the credit risk position (the nominal value of transactions made by the employee is at least 0.5% of LHV Tier 1 own funds and is in the amount of at least EUR 5 million) | 0.53 |

Self-assessment is carried out once a year at the beginning of the financial year. The assessment covers both the past period (including financial results, risk analysis) and takes into account the forthcoming financial year. The specified group of employees that are determined in the course of the self-assessment are required, within one calendar year after exercising the options, to keep the underlying LHV shares in their own possession and to not sell them, or to encumber in any form (including pledge). The specified group of employees are forbidden to transfer the risk of the decline of the share price to other parties, for example, through insurance or certain type of financial instruments. Self-assessment is carried out by taking into account the degree of complexity, performance indicators and structure of LHV. The competence lies on the Management Board, who will conduct the analysis in the form of a discussion at a board meeting. The self-assessment is initiated by the Human Resources department, the compliance of the process and results are assessed by the department of Compliance Control, whose representative is also present at the self-assessment. The Remuneration Committee reviews annually the qualitative and quantitative criteria related to the employee and the self-assessment process, which is used for decision-making. The results of the self-assessment are independently reviewed by the internal audit, the results are summarized and presented to the Supervisory Board.

**Share options**

In 2014, the general meeting of shareholders of AS LHV Group approved the criteria for the granting of share options to the Management Board members and key employees. The aim of issuing share options is to align the interests of Management Board members and employees more effectively with the interests of shareholders and customers. Another objective is to offer a system of compensation on the labour market that is equal to competitors and comprehensive

As part of the program, there is an annual performance pay added to basic salary, the amount or issue of which corresponds to the fulfilment or non-fulfilment of individual and LHV objectives. The objectives of the program are:

- ensuring a competitive remuneration, to be attractive in the labour market;
- keeping and motivating key personnel through creating a relationship of ownership;
- reconciling the interests of shareholders and employees;
- increasing company value through performance management.

The instruments of performance pay under the option program are 100% equity options. The term of share options is 3 years from the moment the options were granted. The three-year vesting period before issuance of shares gives the opportunity to evaluate the results in the long run. It is not possible to take the specified amount in cash in lieu of share options. Share options are issued annually in the amount of up to maximum 2% of the total number of LHV shares. LHV has the right to refuse to exercise and issue equity options to the entitled person, in whole or in part, if:

- LHV General Meeting or the Supervisory Board under the instructions from the General Meeting does not adopt the decision on the increase of LHV share capital and issuance of shares;
- the Management Board member agreement or the employment relationship of the person entitled to receive options has ceased at the initiative of the person entitled to receive options or in pursuant to § 88 of the Employment Contracts Act or, if the Employment Contracts Act is amended, on an analogous basis, however, based on the decision of the Supervisory Board it is possible to make exceptions to the applicability of this paragraph;
- the financial results of LHV or its relevant subsidiary have substantially deteriorated compared to the previous period;
- the person entitled to receive options no longer meets the performance criteria or does not meet the requirements prescribed by law to the head or an employee of a credit institution or a fund management company;
- LHV or its relevant subsidiary no longer meets the prudential regulations or the company's business risks are not adequately covered by own funds;
- the issuance of options has been determined based on information, which proved to be substantially misstated or incorrect.

Similarly to 2014, share options were annually issued from 2015 to 2018. In 2018, the options issued in 2015 were fully exercised. Next share options issue could be in 2019 based on Supervisory Board decision.

The granting and size of share options was dependent upon the successful achievement of operational targets of the overall company and the targets of individual Management Board members and employees. In the beginning of 2018 the share options were granted for 70 people in the amount of 1 458 thousand euros. In the beginning of 2017 the share options were granted for 69 people in the amount of 1 573 thousand euros. In the beginning of 2016, the share options were granted for 49 people in the amount of 826 thousand euros. In 2015, the share options were granted for 48 people in the amount of 681 thousand euros. In 2014, the share options were granted for 35 people in the amount of 645 thousand euros. The company entered into share option agreements with the members of the Management Board and employees for a three-year term for the granting of share options. Share options issued in 2014 were exercised in 2017 where shares with nominal value of 1 euro can be acquired for 2 euros per share. Share options issued in 2015 can be exercised between the period of 01.05.2018-31.07.2018 and shares with nominal value of 1 euro can be acquired for 2.4 euros per share. Share options issued in 2016 can be exercised between the period of 01.05.2019-31.07.2019 and shares with nominal value of 1 euro can be acquired for 3 euros per share. Share options issued in 2017 can be exercised between the period of 01.05.2020-31.07.2020 and shares with nominal value of 1 euro can be acquired for 4.65 euros per share. Share options issued in 2018 can be exercised between the period of 01.05.2021-31.07.2021 and shares with nominal value of 1 euro can be acquired for 4.87 euros per share.

# Governance of the Group

### Supervisory board

**Rain Lõhmus** is a founder of LHV and the chairman of the Supervisory Board of AS LHV Group and a member of the Supervisory Boards of AS LHV Pank and AS LHV Finance. In addition, he belongs to the Supervisory Boards of AS Arco Vara, AS Hortes and Thermory AS. He is the owner and member of the Management Board of AS Lõhmus Holding and the owner of OÜ Mersona Systems. Additionally, he is the Management Board member and one of the owners of Zerospotnrg OÜ and Umblu Records OÜ. Rain Lõhmus graduated from the Tallinn University of Technology (TalTech) and the management program of Harvard Business School. Rain Lõhmus and the persons related to him (Lõhmus Holdings OÜ, OÜ Merona Systems) own altogether 6 478 005 shares, representing 24.9% of all shares.

**Raivo Hein** is a member of the Supervisory Boards of AS LHV Group and AS LHV Pank. Also, he belongs to the Supervisory Board of AS Puumarket. He is the owner and a member of Management Board of OÜ Kakssada Kakskümmend Volti and a Management Board member of OÜ Saarte Sillad and several other companies established for the management of personal investments. Raivo Hein graduated from the Tallinn University of Technology (Tal Tech). Raivo Hein does not own shares of AS LHV Group. The persons related to him, OÜ Kakssada Kakskümmend Volti, Lame Maakera OÜ and Astrum OÜ own altogether 490 110 shares of AS LHV Group.

**Heldur Meerits** is member of the Supervisory Boards of AS LHV Group and was member of Supervisory Board of AS LHV Pank till 23d of December 2018. He also belongs to the Supervisory Boards of the enterprises Kodumaja AS and AS Smart City Group and the foundations SA Põltsamaa Ühisgümnaasiumi Toetusfond, SA Dhama and SA Tähelaps. Heldur Meerits is also the owner and a member Management Board of the companies established for the management of personal economic interests, AS Amalfi and AS Altamira. Heldur Meerits graduated from the Faculty of Economics and Business Administration of the University of Tartu. Heldur Meerits does not own shares of AS LHV Group. AS Amalfi owns 951 978 shares of AS LHV Group.

**Tiina Mõis** is a member of the Supervisory Boards of AS LHV Group and AS LHV Pank. She also belongs to the Supervisory Boards of AS Baltika and Rocca al Mare Kooli SA. She is the owner and the Management Board member of AS Genteel. Tiina Mõis graduated from the Tallinn University of Technology (TalTech). Tiina Mõis does not own any shares of AS LHV Group. AS Genteel owns 999 456 shares of AS LHV Group.

**Sten Tamkivi** is a Supervisory Board member of AS LHV Group. He belongs to the Supervisory Boards of ASI Private Equity AS and Kistler-Ritso Eesti SA. In addition, he is the owner and the Management Board member of Seikatsu OÜ and Osaluste Hellalt Hoidmise OÜ and the Management Board member of Topia OÜ. Sten Tamkivi graduated from the Stanford University Graduate School of Business. Sten Tamkivi and the person related to him, Seikatsu OÜ, own altogether 11 180 shares of AS LHV Group.

**Andres Viisemann** is a founder of LHV and the manager of LHV pension funds. He is a member of the Supervisory Boards of AS LHV Group, AS LHV Pank and AS LHV Varahaldus. He also belongs to the Supervisory Boards of AS Fertilitas and Rocca al Mare Kooli SA. He is also the owner and member of the Management Board of Viisemann Holdings OÜ. Andres Viisemann graduated from the University of Tartu and obtained a Master's degree at INSEAD in International Business Management. Andres Viisemann and the persons related to him (Viisemann Investments AG, Viisemann Holdings OÜ) own altogether 2 549 308 shares, representing 9.8% of all shares. Due to his position as the head of LHV pension funds, Andres Viisemann is entitled to a total of 34,505 shares of AS LHV Group for the options issued in 2016, 2017 and 2018.

**Tauno Tats** is a Supervisory Board member of AS LHV Group. Also, he is a member of the Supervisory Boards of EfTEN Kinnisvarafond AS, AS Ecomet Invest and OÜ Eesti Killustik and a member of Management Board of Ammende Hotell OÜ. He is a Management Board member and one of the owners at Ambient Sound Investments OÜ as well as a Management Board member of companies established for the management of investments of the aforementioned companies. Tauno Tats graduated from the Tallinn University of Technology (TalTech). Tauno Tats does not own shares of AS LHV Group. Ambient Sound Investments OÜ owns 1,595,620 shares of AS LHV Group.

**Management board**

**Madis Toomsalu** is a member of the Management Board of AS LHV Group and the chairman of the Supervisory Boards of AS LHV Pank and AS LHV Varahaldus. He is also member of the Management Board of MTÜ FinanceEstonia. Madis Toomsalu has obtained a Bachelor's degree in business management from the Tallinn University of Technology (TalTech) in 2009 and a Master's degree in 2011 in public sector finance. Madis Toomsalu owns 24 397 shares of AS LHV Group. Madis Toomsalu is entitled to a total of 46 979 shares of AS LHV Group for the options issued in 2016, 2017, 2018.

# Committees formed on Supervisory Board level

### Audit Committee

**Kristel Aarna** works as CFO of AS TV Play Baltics since 2011 and before that was the chief controller of Swedbank Baltic Banking. Previously she has been the head of financial advisory services at KPMG Baltics AS and worked also at Eesti Pank and CVS Caremark Corporation. She is also the owner and the member of the Management Board of IKA Konsult OÜ. Kristel Aarna on has a Bachelor's degree from the Faculty of Economics of the University of Tartu and Master's degree in Business Administration from the Bentley University Graduate School of Business. Kristel Aarna does not have any shares of AS LHV Group.

**Urmas Peiker** is a co-founder of and works as the head of business development in an Estonian start-up Funderbeam. From May 2013 until October 2014, he was the head of Compliance at AS LHV Pank. Previously, Urmas Peiker has worked as the head of Market Supervision Department of the Financial Supervision Authority, also in the European Bank for Reconstruction and Development and Morgan Stanley's. Urmas Peiker has a Bachelor's degree from the University of Tartu and Master's degree in Law from the Duke University in the USA. Urmas Peiker does not have any shares of AS LHV Group.

**Tauno Tats** (Supervisory Board member of AS LHV Group)

### Remuneration Committee

**Madis Toomsalu** (Management Board member of AS LHV Group, chairman of the Supervisory Board of AS LHV Pank and AS LHV Varahaldus)

**Rain Lõhmus** (chairman of the Supervisory Board of AS LHV Group, member of the Supervisory Board of AS LHV Pank and AS LHV Finance)

**Andres Viisemann** (member of the Supervisory Board of AS LHV Group, AS LHV Pank and AS LHV Varahaldus)

**Risk and Capital Committee**

**Rain Lõhmus** (chairman of the Supervisory Board of AS LHV Group, member of the Supervisory Board of AS LHV Pank and AS LHV Finance)

**Tiina Mõis** (member of the Supervisory Boards of AS LHV Group and AS LHV Pank)

**Andres Viisemann** (member of the Supervisory Boards of AS LHV Group, AS LHV Pank and AS LHV Varahaldus)

**Supervisory and management boards of the subsidiaries**

**AS LHV Pank**

Supervisory Board: Madis Toomsalu (chairman, until 05.12.2021), Raivo Hein (until 20.09.2022), Heldur Meerits (until 23.12.2018), Tiina Mõis (until 31.12.2019), Rain Lõhmus (until 31.12.2019), Andres Viisemann (until 20.09.2022)

Management Board: Erki Kilu (chairman, until 20.09.2022), Jüri Heero (until 20.09.2022), Andres Kitter (until 20.09.2022), Meelis Paakspuu (until 20.09.2022), Indrek Nuume (until 20.09.2022), Martti Singi (until 20.09.2022), Kadri Kiisel (until 20.09.2022)

**AS LHV Finance**

Supervisory Board: Erki Kilu (chairman, until 24.08.2023), Rain Lõhmus (until 24.08.2023), Veiko Poolgas (until 24.08.2023), Jaan Koppel (until 24.08.2023)

Management Board Kadri Kiisel (until 05.02.2023)

**AS LHV Varahaldus**

Supervisory Board: Madis Toomsalu (chairman, until 04.12.2021), Erki Kilu (until 28.04.2022), Andres Viisemann (until 28.04.2022)

Management Board: Mihkel Oja (chairman, until 09.10.2022), Joel Kukemelk (09.10.2022)

**Cuber Tehnology OÜ**

Management Board: Jüri Laur (without a term)

# Financial results

| EUR million | 2014* | 2015* | 2016* | 2017* | 2018* |
|---|---|---|---|---|---|
| **Volume of deposits** | **457** | **633** | **778** | **1 543** | **1 444** |
| incl. financial intermediates deposits | 0 | 0 | 32 | 607 | 194 |
| **Volume of net loans** | **316** | **410** | **538** | **732** | **919** |
| **Volume of assets** | **556** | **757** | **935** | **1 773** | **1 677** |
| **Volume of funds** | **504** | **570** | **974** | **1 103** | **1 214** |
| **Volume of custody accounts** | **586** | **1 253** | **1 072** | **1 287** | **1 486** |
| Net interest income | 20.3 | 23.2 | 30.0 | 35.5 | 39.8 |
| Net fee income | 12.8 | 14.7 | 19.2 | 22.2 | 26.0 |
| Net financial income | 0.5 | 0.4 | 1.3 | 1.0 | 3.4 |
| Net income | 33.6 | 38.3 | 50.5 | 58.7 | 70.0 |
| Expenses | 21.7 | 24.1 | 28.9 | 31.9 | 33.8 |
| **Profit before credit losses** | **11.9** | **14.3** | **21.7** | **26.6** | **36.2** |
| **Loan provision** | **2.6** | **1.4** | **1.5** | **3.2** | **5.3** |
| **Tax expense** | **0.5** | **0.9** | **0.3** | **1.2** | **3.8** |
| **Profit** | **9.7** | **14.8** | **19.9** | **22.2** | **27.2** |
| net profit attributable to owners of the parent | 9.2 | 13.7 | 17.8 | 19.6 | 25.2 |

**includes discontinued operations*

The Group's pre-tax profit for 2018 amounted to EUR 30.9 million and net profit totalled EUR 27.2 million. Pre-tax profit is 32% more than a year before. Net interest income grew 12% and net fee income increased 17%. Financial income increased by 246% mainly due to the gain from disposal of UAB Mokilizingas. The Group's net income was EUR 70.0 million and increased by 20% compared to the previous year. From income increase 3.0 million are related to sale of Mokilizingas, remaining increase is related to higer business volumes. Operating expenses amounted to 33.8 million euros and increased by 6% over the year. Most of the cost increase has been related higher business volumes and increased number of employees to offer that. The Group achieved the financial forecast published at the beginning of 2018.

By the end of December, the total volume of the Group's loan portfolio less impairments amounted to EUR 919 million (December 2017: EUR 732 million). The volume of portfolio increased 26% in a year. In the loan portfolio, the majority is corporate loans that increased 30% in a year to EUR 664 million (2017: EUR 510 million). The portfolio of retail loans increased 15% in a year, amounting to EUR 265 million (2017: EUR 230 million).

The volume of Group's deposits decreased 6% in a year and totalled EUR 1 444 million by the year-end (2017: EUR 1 543 million). The share of demand deposits of all deposits remained the same and was 92% (31.12.2017: 92%).

AS LHV Bank's as largest business units net proft for 2018 was EUR 18.4 million, growing 2.9 million compared with previous year. Loans to clients increased by EUR 199 million reaching EUR 919 million. During the year, payment intermediates deposits decreased by EUR 413 million, whereby core banking customers' deposits increased by EUR 314 million reaching EUR 1 448 million by the end of year. Client number increased by 28 thousand.

In 2018 LHV Asset Management earned net profit in amount of EUR 6.8 million, which is EUR 1.0 million more than previous year. Number of second pillar pension funds clients increased by 1.0 thousand to 178 thousand. Net fee income decreased by EUR 0.6 million to EUR 13.9 million. Behind the increase is growth in AUM, what compensated the decrease in management fees. Business expenses decreased by EUR 0.8 million to EUR 5.8 million in 2018. In addition LHV Asset Management decreased share capital by EUR 1.2 million (2017: 15.5) million and paid dividends for 2017 in amount of EUR 4.4 (2017: 5.8) million. LHV Group as a separate entity earned a profit of EUR 11.7 (2017: 2.7) million, due to the fact that the subsidiary LHV Varahaldus and LHV Pank paid dividends to LHV Group and UAB Mokilizingas was sold.

During the year LHV Bank registred branch in UK. LHV did not acquire new subsidiaries. In May 2018 UAB Mokilizingas was sold and this resulted in extraordinary profit of EUR 3.0 million. Due to that also financial plans were renewed for 2018.

**Key figures**
EUR million

| | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| Core Tier 1 CAD % | 17.58 | 15.97 | 15.10 | 14.02 | 14.88 |
| Tier 1 CAD % | 17.58 | 15.97 | 15.10 | 14.02 | 14.88 |
| CAD % | 22.82 | 23.36 | 20.70 | 18.30 | 20.91 |
| MREL % | 15.72 | 14.49 | 12.25 | 7.78 | 11.43 |
| leverage ratio % | 6.92 | 6.84 | 6.96 | 5.01 | 6.56 |
| LCR % | 190.0 | 271.6 | 221.5 | 121.3 | 148.5 |
| NSFR % | - | - | - | 140.8 | 147.6 |
| return on equity (ROE) % * | 21.4 | 21.8 | 20.7 | 17.6 | 18.4 |
| return on assets (ROA) % | 2.00 | 2.3 | 2.4 | 1.6 | 1.6 |
| CFROI % | 26.4 | 25.9 | 23.9 | 22.6 | 25.4 |
| cost to income ratio % | 67.5 | 62.8 | 57.2 | 54.4 | 48.3 |
| net interest margin (NIM) % | 3.50 | 3.62 | 3.60 | 2.66 | 2.34 |
| spread % | 3.44 | 3.55 | 3.52 | 2.62 | 2.32 |
| loan to asset % | 57.42 | 54.54 | 57.86 | 41.61 | 55.24 |
| loan to deposits % | 69.68 | 66.91 | 69.68 | 48.00 | 65.14 |
| price to earnings ratio | - | - | 13.29 | 13.56 | 9.75 |
| dividend to net profit ratio % | - | - | 26.7 | 21.0 | 21.6 |
| dividend per share | - | - | - | 0.15 | 0.16 |

**Explanations**

* Return on equity is calculated based on LHV Group net profit and equity attributable to owners of the parent and does not include non-controlling interest.

capital adequacy levels are calculated as reported in COREP report as at end of each year

MREL = (own funds + qualifying liabilities) / total liabilities * 100

LCR, NSFR are calculates as reported in COREP report as of end of each year

return on equity (ROE) = net profit (attributable to owners of the parent) / average equity (attributable to owners of the parent) * 100

return on assets (ROA) = net profit / average assets * 100

CFROI = Operating profit / capital (average)

cost to income ratio = total operating expenses / total income * 100

net interest margin (NIM) = net interest income/average interest earning assets * 100

spread = yield on interest earning assets – cost of interest bearing liabilities

loan to asset = net loans / total assets * 100

loan to deposits = net loans / deposits * 100

price to earnings ratio = share price/net profit/number of shares (average)

dividend to net profit ratio = dividend/net profit

dividend per share = dividend payment during calendar year / number of shares at moment of payment

**Liquidity and capitalization**

The liquidity coverage ratio (LCR) of the Group, calculated according to the definitions of the Basel Committee, was 148.5% at the end of December (31.12.2017: 121.3%; 31.12.2016: 221.5%). The liquidity situation of the Group has not changed, as the depletion of the LCR is caused by deposits made by financial intermediaries, which are 100% covered by liquid funds. As at 31.12.2018, the Group's LCR is 235.5%, if the deposits from financial intermediaries are not taken into account. The Group considers cash in the central bank and in other credit institutions and bond portfolios to be included in its liquidity buffer, that accounted for 43% of the total of the statement of financial position (31.12.2017: 57%). The Group's loan-to-deposit ratio at the end of 2018 was 64% (31.12.2017: 48%).

The Group's level of own funds as at 31.12.2018 was EUR 183.3 million (31.12.2017: EUR 141.6 million). Compared to the internal capital adequacy target of 15.50%, the Group is well capitalised as at the end of the reporting period. The level of capital adequacy was 20.91% (31.12.2017: 19.6%) and Tier 1 capital ratio was 14.88% (31.12.2017: 15.3%), %), well above the regulatory requirement of 11.3% (31.12.2017: 10.4%).

The Group uses the standard method for the calculation of credit risk and market risk capital requirements and the basic indicator approach for the calculation of operational risk capital requirements. The Group has complied with all capital requirements during the financial year and in previous year.

Each year, an internal capital adequacy assessment process (ICAAP) is performed, the goal of which is to identify potential capital needs in addition to regulatory capital requirements.

Leverage ratio, calculated according to Basel Committee on Banking Supervision requirements, as at 31.12.2018 was 7.31% (31.12.2017: 5.83%). Leverage ratio is calculated as Group's total Tier 1 own funds divided by Group's total risk exposure measure (incl. risk position on assets and off the balance sheet liabilities). As at the end of the reporting period, the leverage ratio is the arithmetic mean of the monthly leverage ratios over the last quarter.

On December 2017, the Financial Supervision Authority introduced a new prudential regulation for LHV Group, a minimum requirement for own funds and eligible liabilities (MREL). The ratio is a part of the crisis resolution plan and obliges LHV to have sufficient own funds and unsecured long-term liabilities that can be used to cover losses under the crisis resolution plan. The minimum requirement for MREL ratio is set at 5.79% and it is reviewed annually by the Financial Supervision Authority. At the end of the year, LHV Group had the ratio at the level of 11.43% (2017: 7.78%) and it contains an adequate buffer for the growth plans of 2019. On the other hand, it forces LHV to change its existing policy of financing by deposits and the Group will also include liabilities in the form of bonds or loans, which qualify for MREL, in order to manage the ratio.

**Capital base**

| (in EUR thousands) | 31.12.2018* | 31.12.2018 | 31.12.2017 |
|---|---|---|---|
| Paid-in share capital | 26 016 | 26 016 | 25 767 |
| Share premium | 46 653 | 46 653 | 46 304 |
| Statutory reserves transferred from net profit | 3 451 | 3 451 | 2 471 |
| Other reserves | 78 | 78 | 36 |
| Accumulated profit/(deficit) | 50 193 | 50 193 | 24 468 |
| Intangible assets (subtracted) | -19 084 | -19 084 | -7 940 |
| Profit for accounting period | 25 237 | 25 237 | 19 603 |
| Deductions | -194 | -194 | 0 |
| Dividend offer (including income tax) | -6 708 | 0 | 0 |
| **Total Tier 1 capital** | **125 642** | **132 350** | **110 709** |
| Subordinated debt | 50 900 | 50 900 | 30 900 |
| **Total Tier 2 capital** | **50 900** | **50 900** | **30 900** |
| Exceeding limitations of subordinated debts and preference shares | 0 | 0 | 0 |
| **Net own funds for capital adequacy calculation** | **176 542** | **183 250** | **141 609** |
| **Capital requirements** | | | |
| Central governments and central bank under standard method | 938 | 938 | 945 |
| Credit institutions and investment companies under standard method | 5 376 | 5 376 | 6 950 |
| Companies under standard method | 579 836 | 579 836 | 428 428 |
| Retail claims under standard method | 133 250 | 133 250 | 144 237 |
| Public sector under standard method | 125 | 125 | 185 |
| Housing real estate under standard method | 39 903 | 39 903 | 20 039 |
| Overdue claims under standard method | 10 142 | 10 142 | 20 956 |
| Investment funds' shares under standard method | 7 973 | 7 973 | 6 281 |
| Other assets under standard method | 10 557 | 10 557 | 13 824 |
| **Total capital requirements for covering the credit risk and counterparty credit risk** | **788 090** | **788 090** | **641 845** |
| Capital requirement against foreign currency risk under standard method | 3 957 | 3 957 | 3 551 |
| Capital requirement against interest position risk under standard method | 32 | 32 | 412 |
| Capital requirement against equity portfolio risks under standard method | 704 | 704 | 585 |
| Capital requirement against credit valuation adjustment risks under standard method | 41 | 41 | 15 |
| Capital requirement for operational risk under base method | 91 575 | 91 575 | 75 999 |
| **Total capital requirements for adequacy calculation** | **844 399** | **884 399** | **722 407** |
| **Capital adequacy (%)** | **20.91** | **21.70** | **19.60** |
| **Tier 1 Capital Ratio (%)** | **14.88** | **15.67** | **15.32** |

*audited numbers which include the dividend offer

**Financial plan**

Starting from 2018 LHV has published financial plan for next five years. As the forecast horizon is long, then only the first year should be taken commitment, remaining four years as guideline where LHV sees it's business to develop.

Assumptions behind the financial plan

Biggest assumption is regarding the macroeconomic situation, where we knowledable to not plan major changes to present the actual development of LHV without significant effects of economic environment. In addition, we consider competition to remain similar to current situation. two largest changes taken into account: already known changes in legislation and market view regarding interest rates. Based on this plan interest rates will start raising in 2020 and will have positive impact to years 2021-2023. This plan LHV continues to have three business arms, from which Estonian banking and asset management arms two are solid already now, where the share of payment intermediates business line will start increasing.

**Profita and loss statement**
EURm

| | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|
| Net interest income | 48 | 61 | 77 | 91 | 112 |
| Net fee and commission income | 25 | 29 | 32 | 36 | 41 |
| Net gains from financial assets | 0 | 0 | 0 | 0 | 0 |
| Other income | 0 | 0 | 0 | 0 | 0 |
| **Total revenue** | **73** | **90** | **109** | **127** | **153** |
| **Total operating expenses** | **-33** | **-37** | **-42** | **-47** | **-51** |
| Amortization | -3 | -4 | -4 | -4 | -4 |
| Impairement losses on loans and advances | -4 | -6 | -8 | -10 | -11 |
| **Earning before income tax** | **32** | **42** | **55** | **67** | **87** |
| Income tax | -2 | -2 | -3 | -3 | -3 |
| Advance income tax | -3 | -4 | -6 | -7 | -9 |
| **Net profit** | **27** | **36** | **46** | **57** | **74** |
| Profit attributable to non-controlling interest | 2 | 2 | 2 | 3 | 3 |
| **Profit attributable to owners of the parent** | **25** | **34** | **44** | **55** | **71** |

**Balance sheet**
EURm

| | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|
| Cash and cash equivalents | 837 | 965 | 1 133 | 1 287 | 1 396 |
| Financial assets at fair value | 85 | 105 | 112 | 112 | 112 |
| Loans grante (net) | 1 181 | 1 448 | 1 786 | 2 094 | 2 409 |
| Long-term financial investments | 7 | 8 | 6 | 7 | 7 |
| Other assets | 27 | 32 | 34 | 36 | 38 |
| **Total assets** | **2 138** | **2 558** | **3 071** | **3 535** | **3 963** |
| Deposits from customers | -1 863 | -2 195 | -2 561 | -2 951 | -3 313 |
| Loans received | -32 | -82 | -182 | -207 | -207 |
| Subordianted loans | -55 | -60 | -65 | -65 | -65 |
| Other liabilities | -6 | -7 | -8 | -9 | -9 |
| **Total liabilities** | **-1 957** | **-2 345** | **-2 817** | **-3 232** | **-3 595** |
| **Equity** | **-180** | **-213** | **-254** | **-303** | **-368** |
| **Total liabilities and equity** | **-2 138** | **-2 558** | **-3 071** | **-3 535** | **-3 963** |

| **Financial and operational ratios** | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|
| ROE from profit attributable to the owners of parent | 15.4% | 17.8% | 19.3% | 20.1% | 21.7% |
| ROE from pretax profit attibutable to the owners of the parent | 18.3% | 20.8% | 22.8% | 23.5% | 25.4% |
| C/I | 50% | 46% | 43% | 40% | 36% |
| L/D | 63% | 66% | 70% | 71% | 73% |
| Risk cost | 0.4% | 0.5% | 0.5% | 0.5% | 0.5% |
| EPS (EUR) | 0.97 | 1.28 | 1.63 | 2.01 | 2.59 |
| Dividend (EURt) | 5 463 | 5 513 | 7 187 | 9 422 | 11 431 |
| DPS (EUR) | 0.21 | 0.21 | 0.27 | 0.35 | 0.42 |
| T1 | 13.7% | 14.0% | 14.5% | 15.3% | 16.5% |
| CAD | 19.0% | 18.9% | 19.1% | 19.3% | 20.0% |

### Sensitivity analyses

LHV has two major business lines: banking and asset management. These business lines are very different in their sensitivities to different risk factors.

Bank is clearly procyclical, meaning that it's results are directly affected by macroeconomic developments. In general, there are three major components effecting Bank's results:

- **Interest rate**
- **Credit losses**
- **Personnel cost**

Every 100 bps increase in interest rates will increase LHV interest income by EUR 1 million within first 12 months. Interest rate decrease by similar level will reduce LHV interest income by EUR 0.3 million.

Credit losses are dependent on economic situation. LHV has knowledable credit risk management and does not allow excess risk in any of the economic sectors. Still quick growth hides the credit losses as significant part of portfolio is not matured yet. For understanding the actual levels of credit losses, LHV calculates the credit risk in addition to current portfolio also to 12 month old portfolio. LHV has had very few defaults in history and only real credit losses bank has had have been related rather with fraud, not with wrong credit decisions.

Personnel cost is the biggest cost base for the bank and equals around 50% of the total costs. LHV has the internal policy to follow the market leveles in compensation packages. LHV offers its services mainly through electronic channels. To offer these services effectively LHV has made a decision to develop systems in-house. As a result the IT team is almost 25% of the total personnel. Salary levels for IT personnel has been increasing and seems to increase in nearest future more than for other personnel segments, then LHV has forecasted higher salary growth than competitors.

Asset management is almost insensitive to macroeconomic developments. The results are depending on two major items:

- **Pension fund manangement**
- **Political risk**

Pension fund manangement is key for results. Starting from Q4 2019 the calculation of fund manangement fees will be changed to performance bonus principle. The target is to beat the agreed benchmark. LHV has outperformed all our competitors over the last 10 years.

Another large risk side of the asset management is political risk. In every year during the last 5 years there has been some changes in the pension funds management fee calculation. LHV has been successful of managing these changes and being able to deliver good result despite of the constant changes in legislation.

# Overview of the Group's subsidiaries in 2018

## AS LHV Pank consolidation group

LHV's mission is to help raise Estonian capital. LHV's vision is focused on Estonia where people and businesses dare to think big, engage in enterprise and invest in the future. The values of LHV are simplicity, support, performance.

LHV Bank (hereinafter the Bank) is the largest domestic bank. The Bank focuses on active and independent customers with an entrepreneurial mind-set. For private customers, the Bank mainly offers services related to the safeguarding and growing of savings. For business customers, the Bank offers flexible and appropriate financing, along with the management of daily financial affairs. The Bank's products and services are simple, transparent and relevant. Modern-day electronic means of communication are used for customer relations. The cost optimization is reflected in the affordable prices of the Bank's everyday services.

The Bank has representative offices in Tallinn, Tartu and London. The Bank has more than 350 staff members, with more than 160,000 customers using the Bank's services. The Bank consolidates a 65% subsidiary AS LHV Finance, engaged in consumer financing (hereinafter the Group).

**Business activities**

The number of new customers grew at an unprecedented speed in 2018. Customer numbers grew by 28,000, year-over-year, with the bank's customer base reaching 160,000. The year saw a record-breaking growth in customer activity. The bank participated in the IPO of the Port of Tallinn as co-organiser of the retail offer, with a half of the subscribers of the Port of Tallinn originating from LHV Bank.

Deposit volumes decreased by 7%, amounting to EUR 1,444 million by the end of the year. Standard customer deposits grew by 33% to EUR 1,250 million, with the deposits of financial institutions shrinking by 68% to EUR 194 million. A cooperation agreement was concluded with the deposit engagement platform Raisin, aiming at engaging longer-term deposits beyond the borders of Estonia. At the end of the year, the bank entered into a loan agreement with Nordic Investment Bank with the aim of expanding the eligible liabilities forming the basis for MREL.

The bank's loan stock grew by 26%, year-over-year, amounting to EUR 919 million. Corporate loans grew by 30% to EUR 651 million and retail loans by 44% to EUR 268 million. Housing loans remained the greatest contributor to retail loans, followed by leasing, private loans, small loans and hire-purchase.

The bank posted a profit of EUR 20.9 million, before taxes. Profit was positively affected by the increase in commission fees from the realisation of institutional banking transactions, and negatively by the impairement of a corporate loan. New credit loss principles were fully adopted at the beginning of the year in accordance with IFRS 9. This had a minor impact on the impairment of loans. The bank was subjected to the advance income tax liability in April, charged directly to expenses. Net profit for the year amounted to EUR 18.4 million.

The Financial Supervision Authority submitted its annual supervisory assessment and the additional own funds requirement in the capital adequacy calculations. Changes were introduced in both the composition of and the requirements for additional own funds, compared to last year. Considering the larger systemic risk buffer imposed on the bank as of 1 January 2019, the Supervisory Board decided to set the minimum own funds ratio at 15.50%. At the beginning of the year, the bank's share capital was increased by EUR 10 million. At the end of the year, the bank issued new subordinated bonds of AS LHV Group in the total amount of EUR 10 million, with the aim of strengthening the bank's capital base for expanding business volumes.

Moody's Investors Service gave the bank an investment grade rating of Baa1, with a stable outlook. It was the first time ever for the bank to receive a credit rating from an international rating agency. In establishing the rating, Moody's took account of the bank's strong capitalisation and profitability, which balances the bank's aggressive growth and the relatively recent loan portfolio. The credit rating will help international business pursuits, facilitating correspondent relations with other banks, cooperation with international institutions in the provision of financing solutions or guarantees to customers, and enhancing the options of trade financing.

At the end of the quarter, the bank and AS Versobank (under liquidation) entered into a contract, pursuant to which the bank will acquire EUR 18.4 million worth of AS Versobank's loan stock. The exact price will be determined based on the claims outstanding as of 1 January 2019. The price depends on outcome of due diligence process. The price will be paid in lump sum upon completion of the transaction. The loan portfolio will be acquired as a loan stock company, consisting of loan and collateral agreements and two employees associated with the portfolio. The claims arising from the loan portfolio against Estonian corporate customers amount to nearly EUR 17 million, and the claims against Estonian-resident private customers to nearly EUR 3 million. Pursuant to the contract, the acquisition transaction is scheduled to be completed on 15 February 2019, with the satisfactory results of the audit of the loan portfolio serving as the precondition for completion of the transaction.

The auditor has provided other assurance services to the bank in 2018, as required by the Credit Institutions Act and the Securities Markets Act.

**Development activities**

Major new products included the launch of factoring services in the first half of the year and the provision of Youth Bank services in the second half of the year, consisting of the purchase-insured debit card with discounts of various partners, the state-secured student loan and micro-investment services.

At the end of the year, the bank joined the EBA Clearing Instant Payments real-time euro payment system, adopting the transcript payments system and real-time incoming euro payments. Real-time outgoing euro payments will be adopted at the beginning of next year.

Minor innovations included launch of the small payment option, the option of withdrawing cash with a bank card in stores, e-identification of adult private customers for opening a bank account with an ID-card, Mobile-ID or Smart-ID via the internet bank, the LHV car insurance in cooperation with Compensa, consisting of the LHV motor third party liability insurance, LHV casco insurance and LHV super casco insurance, as well as the purchase and sale of Baltic shares via mobile bank.

**Organisation**

The bank's organisational structure was divided into three major business areas: retail banking, corporate banking and financial institutions, and three major supporting areas: IT, financial management and support services, and risk management. Human resource management, and marketing and communication were the activities pursued across the bank.

In the middle of the year, a new member was introduced in the bank's management board, in charge of the retail banking area. The former head of the retail banking area moved on to manage the financial institutions area and head the UK branch. Consequently, the bank's organisational structure was changed, especially with regard to retail banking and financial institutions.

Four major product management areas were created during the year: customers and channels, investment, financing and payment services. The aim of creating the product management areas was to centralise the management of similar products at a level lower than the management, and to improve the cooperation between product management and development in specific product groups.

On January 28 2018, the UK's financial supervision authority made a positive decision with regard to the establishment of the branch in United Kingdom. The branch in UK was officially opened in London on March 19. With the UK leaving the EU, we initiated the process of registering the branch as a branch of a third-country bank in the financial supervision authorities of both Estonia and United Kingdom.

Year-over-year, the bank's employee numbers grew by 57 to 377 (including passive and part-time staff members), including 35 staff members of LHV Finance. In full time equivalents, the number of active employees amounts to 345, compared to 288 in end of 2017.

The bank received several recognitions during the year. At the beginning of the year, the bank's private banking service won international acclaim, with Euromoney declaring LHV Bank the best private banking service provider in Estonia. In the middle of the year, Euromoney declared LHV Bank the best bank in Estonia.

**Sponsorship**

The bank takes its social responsibility seriously. Within the limits of our available resources, we support enterprises and initiatives that contribute to the development of the Estonian society. When it comes to sponsorship projects, the bank prefers long-term dedication and cooperation. The bank stands ready to contribute to the pursuit of innovative ideas which help to advance Estonian life.

The bank's long-term partners include Estonian Football Association, Estonian Optimist Class Association, Estonian Gazelle Movement, Estonian Entrepreneur of the Year competition, Estonian Music Days and the Enn Soosaar Foundation.

**Financial results**

| EUR million | 2018 | 2017 | change |
|---|---|---|---|
| Net interest income | 39.02 | 31.13 | 25% |
| Net fee and commission income | 11.10 | 7.70 | 44% |
| Net gains from financial assets | 0.47 | 0.68 | -31% |
| Total net operating income | 50.59 | 39.51 | 28% |
| Other income | 0.95 | 0.01 | 94% |
| Operating expenses | -25.74 | -20.42 | 26% |
| Income tax expense | -2.51 | 0.0 | - |
| Credit losses | -4.88 | -3.58 | 36% |
| Net profit | 18.41 | 15.52 | 19% |

**Volumes**

| EUR million | 31.12.2018 | 31.12.2017 | change |
|---|---|---|---|
| Loan portfolio | 918.8 | 719.4 | 28% |
| Bond portfolio | 39.0 | 50.0 | -22% |
| Deposits | 1 444.0 | 1 551.0 | -7% |
| Equity | 125.6 | 99.5 | 26% |
| Number of customers holding assets in the bank | 161 357 | 133 655 | 21% |

# AS LHV Varahaldus

AS LHV Varahaldus is a fund management company with 2 UCITS, 7 mandatory and 2 voluntary pension funds under management as at the end of the year. The organisational structure of LHV Varahaldus consists of four units: the investment management, risk management, operations and sales unit.

In 2018, the assets under management grew from EUR 1 103 million to EUR 1 214 million. The growth was based on the organic growth of the mandatory funded pension system in Estonia. The majority of the assets under management are in the mandatory pension funds. LHV is an active fund manager, making also investments into alternative asset classes and non-listed securities. Such investments are mostly local and as a result LHV's pension funds are the largest by investments into the Estonian investment market.

In March LHV started a new pension fund, which invests purely into Estonia. But in order to offer clients a wider choice, LHV is offering also passively managed mandatory and voluntary pension funds since 2016, which invest only in the largest global markets. The number of funds under management did not change in 2018, as even LHV started a new mandatory pension fund, it also merged two voluntary pension funds in the end of February.

2018 was a difficult year for investors, as only a few markets ended the year with a positive return. For instance, in euro terms European equities lost on average -10.6% of their value, emerging markets lost -10.3% and the Estonian stock market, although better than previously mentioned regions, ended the year with -6.4%. Bond indices offered some protection from the negative stock markets in 2018 as Bloomberg Barclays Euro Aggregate Bond Index returned +0.4% in euros. For euro-based investors a positive contributor was US dollar, which strengthened against euro +4.7%. In this environment LHV's five actively managed pension funds (ex the new fund founded in 2018) managed to protect savings with annual returns between -0.1% and +1.1%. These were the best results among actively managed mandatory pension funds in Estonia. In comparison, LHV's passive fund tracking global and emerging market stock indices and developed market real estate indices lost -5.4% of its unit value.

The number of clients who save with LHV mandatory pension funds increased slightly over the year. 178 thousand participants have directed their monthly pension contributions to one of the LHV's pension funds, which gives a market share of 25.2%. In terms of assets under management, LHV's market share is 30.2% in the mandatory pension market.

In December the parliament decided to make amendments into the Investment Funds Act. The amendments will have a significant effect on pension funds, as well as fund management companies. Main changes are related to the fee structure of the mandatory pension funds – fixed management fee will be reduced significantly, but a performance related success fee introduces simultaneously. At the same time investment rules are relaxed, so that pension fund managers have wider opportunities to set their investment strategies. Most of the changes come into effect in September 2019.

The net profit of LHV Varahaldus was EUR 6.8 million in 2018, an annual increase by EUR 1.0 million. The profit was affected by dividend income tax in amount of EUR 1.1 million (EUR 1.0 million in 2017). Net fee and commission income increased by EUR 0.6 million to EUR 13.9 million. Operating expenses decreased by EUR 0.9 million and amounted to EUR 5.8 million. LHV Varahaldus achieved lower operating expenses due to the reduction of the cost of purchased services. LHV Varahaldus paid EUR 4.4 million in dividend and reduces the share capital by EUR 1.2 million in 2018.

### Financial results

| EUR million | 2018 | 2017 | change |
|---|---|---|---|
| Net fee income | 13.9 | 13.3 | 5% |
| Other financial income | -0.2 | 0.2 | -200% |
| Total net operating income | 13.7 | 13.5 | 1% |
| Operating expenses | -5.8 | -6.7 | -13% |
| Income tax expemses | -1.1 | -1.0 | 10% |
| Net profit | 6.8 | 5.8 | 17% |
| Assets under management | 1 214 | 1 103 | 10% |
| Number of clients in pension funds (thousands) | 201 | 202 | -0.5% |

# Corporate Governance report

This report is presented in accordance with the Accounting Act of the Republic of Estonia and provides an overview of the governance of AS LHV Group (hereinafter: LHV) and compliance of governance with the advisory guidelines Corporate Governance Recommendations of the Financial Supervision Authority and Nasdaq Tallinn Stock Exchange. LHV adheres to the Corporate Governance Recommendations, unless specified otherwise in this report.

**1. General meeting**

LHV is a public limited company, with its governing bodies being the General Meeting of Shareholders, the Supervisory Board and the Management Board.

The General Meeting, where shareholders can exercise their rights, is the highest governing body of LHV. The primary duties of the General Meeting include amendment of the Articles of Association, increase and decrease of share capital, decisions on issuance of convertible bonds, election of and extension of the powers of Supervisory Board members, premature removal of Supervisory Board members, approval of the annual report and profit allocation, approval of the share option programme and establishment of terms and conditions for the realisation of options, determination of the number of auditors, appointment and recall of auditors and other decisions within the competence of the General Meeting, as provided by law and the Articles of Association.

A resolution on amendment of the Articles of Association shall be adopted if at least two-thirds of the votes who participate in the meeting are in favour. A resolution on amendment of the Articles of Association shall enter into force as of the making of a corresponding entry in the commercial register. The resolution of the General Meeting on the amendment of the Articles of Association, minutes of the General Meeting and the new text of the Articles of Association shall be attached to the application filed with the commercial register.

A shareholder has the right to participate in the General Meeting, address the General Meeting with regard to items on the agenda, ask relevant questions and make proposals.

The Management Board calls the General Meeting. The annual General Meeting, with the approval of the annual report on the agenda, is held at least once a year. The Management Board calls the annual General Meeting within six months after the end of the financial year at the latest. The Management Board gives at least three weeks' notice of the annual or special General Meeting.

The agenda of the General Meeting, proposals of the Management Board and Supervisory Board, draft resolutions and other relevant materials are made available to the shareholders prior to the General Meeting. Materials are made available on LHV's website. Shareholders are given the opportunity to ask questions about items on the agenda before the General Meeting, with the questions and responses published on LHV's website.

The list of shareholders entitled to participate in the General Meeting is established based on the share register seven days before the General Meeting.

One annual General Meeting of shareholders was held in 2018. No special General Meetings were held. The annual General Meeting of shareholders was held on April 11, 2018, where the Annual Report 2017 was approved and profit for the financial year 2017 was distributed, including the payment of dividends was decided. In addition, an overview of the financial results and the business environment of the first two months of 2018 was given and an auditor was appointed for the financial years 2018-2019. The General Meeting was held in the Estonian language.

The Annual General meeting of 2018 was chaired by Daniel Haab, Head of Legal Department of AS LHV Pank, who introduced the procedure of the General Meeting and the procedure for asking questions regarding the company's activities from the Management Board.

In 2018, member of the Management Board Madis Toomsalu, Chairman of the Supervisory Board Rain Lõhmus, members of the Supervisory Board Andres Viisemann, Tiina Mõis, Raivo Hein, Sten Tamkivi and Tauno Tats; Andres Viisemann and Heldur Meerits were represented by a power of attorney. Also, the auditors of the financial year 2017, and the auditor's candidate for the financial years 2018-2019, Ago Vilu and Verner Uibo, attended the annual General Meeting.

None of the shareholders hold any shares, which would grant them special control rights or voting rights. LHV is not aware of any agreements in place between shareholders that would address the coordinated exercise of shareholder rights.

Shareholders with significant influence are Rain Lõhmus and the persons related to him (24.9%) and Andres Viisemann and the persons related to him (9.8%).

## 2. Management board

### 2.1. Membership and duties of the Management Board

The Management Board is a governing body of LHV, representing and managing LHV. The members of the Management Board are elected and removed by the Supervisory Board. In order to elect a member of the Management Board, the candidate's written consent is required. Persons with knowledge and experience sufficient for participating in the work of the Management Board and for fulfilling the duties of a member of the Management Board and who correspond to the requirements, arising from the LHV's Articles of Association, rules of procedure of the Management Board and other internal rules of procedure and legislation, shall be appointed members of the Management Board. Before the appointment, the individual suitability of the person for the position is assessed pursuant to the LHV's procedure on the assessment of the members of the management body and key personnel, following the criteria established in the guidelines on the assessment of suitability of the financial Supervision Authority, considering also the specific nature of LHV's business operations. According to the referred procedure on the assessment of suitability, also the collective suitability of Management Board as the governing body is assessed in respect of the available sufficient knowledge, competence, managerial skills and diversity in business areas important for LHV.

Pursuant to the Articles of Association of LHV, the Management Board consists of one to five members. A member of the Management Board is appointed for a term of five years, unless otherwise decided by the Supervisory Board. An extension of the term of office of a member of the Management Board may not be decided before one year before the scheduled end of the term of office and for a longer period than the maximum period prescribed in the law or the Articles of Association. If the Management Board of LHV has more than two members, the Supervisory Board must appoint the Chairman of the Management Board. The Chairman of the Management Board organises the work of the Management Board. The Supervisory Board may remove a member of the Management Board regardless of the reason. A member of the Management Board may resign from the board, regardless of the reason, informing the Supervisory Board thereof. The rights and obligations arising from a contract concluded with a member of the Management Board shall expire in accordance with the contract.

The LHV Management Board currently consists of a single member and Madis Toomsalu serves as the member of the Management Board. The Supervisory Board has entered into a Management Board member contract with Madis Toomsalu. The Supervisory Board establishes the remuneration principles for Management Board members and sets the severance compensation policy for premature termination of the Management Board member contract. The authority of the member of the Management Board shall continue until December 5, 2021.

The Management Board makes everyday management decisions at its own discretion, governed by the best interests of LHV and its shareholders, and not their personal interests. The duties of the Management Board member include day-to-day management of LHV, representation of the company, management of LHV's operations in foreign markets and investor communication, coordination of the development of LHV's strategy and its implementation by serving as an active chairman of the Supervisory Boards of the major subsidiaries of LHV.

The Management Board shall ensure the functioning of adequate risk management and internal control within LHV, depending on the business area pursued by LHV. LHV's internal control system covers all activities carried out by the Supervisory Board, management and staff members of LHV with the aim of ensuring efficiency of operations, adequate risk management, reliability and accuracy of internal and external reporting, correspondence to reality and unconditional compliance with all legal acts. The internal control system covers all business, support and control units.

The objective of risk management within LHV is to recognise, correctly measure and manage the risks. On a wider horizon, the objective of risk management is to enhance corporate value by minimising loss and reducing volatility of results.

Risk management is based on a strong risk culture and is built on the principle of three lines of defence, with the first line of defence, i.e. business areas, being responsible for risk-taking and day-to-day management of risks. The second line of defence, i.e. the risk management area, is responsible for developing risk management methods and reporting on risks. The third line of defence, i.e. internal audit, exercises independent supervision over the entire organisation.

### 2.2. Remuneration principles of the members of the Management Board

The purpose of establishing remuneration principles within LHV is the organisation of fair, motivating and transparent remuneration in accordance with the law.

Competence for the establishment of remuneration principles and remunerations for members of the Management Board shall lie with the Supervisory Board. The Remuneration Committee shall review the basis for the remuneration of the Management Board on an annual basis. In assessing the activities of the members of the Management Board, the Remuneration Committee shall, above all, consider the professional duties of the Management Board member, their activities, the activities of the entire Management Board as well as LHV's financial position, the current status of and outlook for business operations in comparison with companies operating in the same sector of economy.

The remuneration payable to a member of the Management Board, including the options programme, must motivate the individual to operate within the best interests of LHV. The basic salary and remuneration principles of members of the Management Board shall be set forth in the employment contract or Management Board member contract concluded with the respective persons. The principles of remuneration of the Management Board or staff members engaged in internal control and risk management shall ensure their independence and objectivity in the performance of their risk management/internal control duties. The remuneration of this staff shall not depend on the results posted by the units supervised. The objectives shall be described on the level of individual staff members.

When measuring the key quantitative and qualitative results and assessing the risk, LHV shall be governed by the following principles:

The performance criteria established by LHV must not stimulate excessive risk-taking or sale of unsuitable products.

The performance criteria must not merely contain performance efficiency indicators (e.g. profit, revenue, profitability, expenditure and volume indicators) or market-based indicators (e.g. stock price or bond yield) but must also be adjusted with risk-based indicators (e.g. capital adequacy, liquidity).

The criteria used for measuring risks and results shall be as closely related to the decisions of the staff member, whose results are being appraised, as possible, and should ensure that the process of the establishment of the remuneration would have an appropriate impact on the staff member's professional behaviour.

A good balance of both quantitative and qualitative as well as absolute and relative criteria shall be used in the specification of the performance criteria.

Quantitative criteria shall cover a sufficient period of time, so as to consider the risks taken by the staff members or business units. The criteria shall be risk-adjusted and contain economic efficiency indicators.

Examples of qualitative criteria include achievement of strategic objectives, customer satisfaction, adherence to the risk management policy, adherence to internal or external rules of procedure, management skills, team-work, creativity, motivation and co-operation with other business units and the internal control function.

LHV applies the long-term incentive (LTI) plan, i.e. the options programme. An annual performance pay shall be added to the basic salaries of Management Board members, top managers and key personnel included in the options programme (including staff members equivalent to the Management Board members), the amount and disbursement of which corresponds to the achievement or non-achievement of individual targets or LHV's targets. The basis for establishment of performance pay in the options programme shall be objective and justifiable, with the time period for which performance pay shall be paid previously determined. The performance pay instruments consist fully of stock options.

Severance compensation payable to a member of the Management Board shall correspond to their previous work results. No severance compensation shall be paid, if this damages the interests of LHV. The size of the severance compensation shall correspond to the results achieved over time, and to the remuneration received.

In 2018, salaries and other compensations paid to the management of LHV and its subsidiaries totalled EUR 1,471 thousand (2017: EUR 1,371 thousand), including all taxes. The remuneration/salaries and compensations of the members of the Management Board of LHV subsidiaries are included in the above total sum, whereas as at the end of 2018, the Management Board of AS LHV Pank included seven members, AS LHV Finance (subsidiary of AS LHV Pank) one member, AS LHV Varahaldus two members and OÜ Cuber Technology one member. Also, the sum includes the salaries and compensations of a 3-member Management Board of UAB Mokilizingas, the majority shareholding of which was transferred in May 2018. Currently, the Management Board of LHV contains one member and the remuneration paid to the member of the Management Board, Madis Toomsalu, under the contract of the member of the Management Board for 2018 is also included in the above total sum. The member of the Management Board of LHV, Madis Toomsalu, can receive as performance pay for the options issued in 2016, 2017 and 2018, 46,979 shares of AS LHV Group; there are no additional bonuses and benefits applicable to the member of the LHV's Management Board.

### 2.3. Conflicts of interests

The members of the Management Board submit a declaration of economic interests and conflicts of economic interests once a year. There have been no conflicts of interest; accordingly, the respective improvement measures have not been applied.

Transactions between LHV and the members of the Management Board, their close relatives or related persons and the terms and conditions thereof must be previously approved by the Supervisory Board. In 2018, no such transactions were concluded between the members of the Management Board, their close relatives or related persons and LHV; also, there are no such valid contracts from earlier periods.

Madis Toomsalu is not a Management Board member or Supervisory Board member in any other issuer. Management Board members of LHV have not been granted authority to issue or buy back shares.

## 3. Supervisory Board

### 3.1 Membership and duties of the Supervisory Board

The Supervisory Board is a governing body of LHV, planning the activities of LHV, organising the management of LHV and conducting supervision over the activities of the Management Board. The Supervisory Board determines and regularly reviews LHV's strategy, the general plan of action, risk management principles and the annual budget. The Supervisory Board has five to seven members. The members of the Supervisory Board are appointed for a term of three years. The members of the Supervisory Board elect amongst themselves the Chairman of the Supervisory Board, who organises the activities of the Supervisory Board. Election and extension of the mandate of the Supervisory Board members is within the competence of the General Meeting of Shareholders.

Persons with knowledge and experience sufficient for participating in the work of the Supervisory Board and fulfilling the duties of a member of the Supervisory Board and who correspond to the requirements, arising from the Articles of Association, rules of procedure of the Supervisory Board and other internal rules of procedure and legislation, shall be appointed members of the Supervisory Board. Before the appointment, the individual suitability of the person for the position is assessed pursuant to the LHV's procedure on the assessment of the members of the management body and key personnel, following the criteria established in the guidelines on the assessment of suitability of the Financial Supervision Authority, considering also the specific nature of LHV's business operations. According to the referred procedure on the assessment of suitability, also the collective suitability of the Supervisory Board as the governing body is assessed in respect of the available knowledge, competence, managerial skills and diversity in business areas important for LHV.

The members of the Supervisory Board of LHV are Rain Lõhmus (Chairman), Andres Viisemann, Tiina Mõis, Heldur Meerits, Raivo Hein, Tauno Tats and Sten Tamkivi. The term of office of Supervisory Board members is set to expire on 29 March 2020.

A total of eleven ordinary meetings of the Supervisory Board were held in 2018 and twice, the decisions were approved electronically. Andres Viisemann, Tiina Mõis and Raivo Hein participated in all meetings of the Supervisory Board in 2018. Rain Lõhmus, Sten Tamkivi and Tauno Tats were absent on one occasion, Heldur Meerits on three occasions. All members of the Supervisory Board participated in more than half of the meetings of the Supervisory Board.

The Supervisory Board has formed three committees, charged with the task of advising the Supervisory Board in issues related to audit, remuneration and risk, as described in clauses 3.3-3.5 of this report.

During the meetings, the Supervisory Board received regular overviews of LHV's and its subsidiaries' operating and financial results, the activities, developments and results of the related areas. Risk reports and internal auditor's reports were quarterly reviewed. In the beginning of the year, the Supervisory Board approved the Annual Report 2017, Management Report and proposal of profit distribution and made a proposal to pay dividends in the net sum of 16 cents per share. The financial and capital plan, capital targets, as well as the 5-year financial forecast and the financial calendar were approved for the year 2018. In August, most of the meeting focussed on the discussions over the strategy of LHV and its subsidiaries. During the year, dozens of procedures, policies and internal rules of LHV and its subsidiaries were reviewed, updated and approved. The procedure rule of the Remuneration Committee was reviewed and amended and the mandate of the members of the remuneration Committee were extended. The pricing of options and issuing of share options for the results of the year 2017, and realisation of options were approved. A consent was given for increasing the share capital of AS LHV Pank and reducing the share capital of AS LHV Varahaldus. The share capital of LHV was increased in connection with the realisation of options programme. The LHV's bond programme and the initial public offering of LHV's subordinated bonds planned under the programme were approved.

### 3.2. Remuneration principles of the Supervisory Board and conflicts of interest

The size of remuneration and its procedure of payment to the members of the Supervisory Board is decided by the General Meeting, considering, i.a. the duties of the Supervisory Board and their extent, as well as the participation at the Supervisory Board meetings and the activity of the Supervisory Board as a governing body. Additional remuneration may be determined to a member of the Supervisory Board in connection with their participation in the activity of the Audit Committee or any other body of the Supervisory Board.

The General Meeting of Shareholders has resolved to establish for the Supervisory Board members a gross remuneration of 500 euros per each meeting of the Supervisory Board, where the member participates. The remuneration payable to the Supervisory Board member is paid out on the next working day following the Supervisory Board meeting. No separate additional pay or performance pay or additional bonuses or benefits have been established.

In 2018, the total sum of remuneration paid to the LHV's Supervisory Board was 35 500 euros, inclusive of all taxes, out of which, 5 000 euros to the Chairman of the Supervisory Board Rain Lõhmus, 5 500 euros to the members of the Supervisory Board Andres Viisemann, 5 500 euros to Tiina Mõis, 4 000 euros to Heldur Meerits, 5 500 euros to Raivo Hein, 5 000 euros to Sten Tamkivi and 5 000 euros to Tauno Tats.

For reasons of clarity, LHV considers it important to note that in case of the Supervisory Board member Andres Viisemann, LHV applies the LTI plan, i.e. the option programme based on his activity as the head of pension funds in LHV's subsidiary AS LHV Varahaldus. The LTI instrument includes 100% share options. Andres Viisemann is entitled to a total of 34 505 shares of AS LHV Group for the options issued in 2016, 2017 and 2018.

Once a year, the members of the Supervisory Board submit a declaration of economic interests and conflicts of economic interests. No significant transactions were concluded between LHV and its Supervisory Board members, their close relatives or related parties in 2018. Also, there are no such valid contracts from earlier periods. There has been no conflict of interest; accordingly, no respective improvement measures were applied.

### 3.3 Audit committee

The Audit Committee is formed by Supervisory Board as an advisory body for monitoring the effectiveness of accounting and reporting (including budgeting process), audit, risk and capital management, internal control system and internal audit, also compliance with regulations. The Audit Committee is governed, in its activities, primarily by the Auditors Activities Act and the rules of procedure established by the Supervisory Board of LHV.

One of the objects of the Audit Committee is to monitor and analyse the processes, which must ensure accurate and efficient preparation of monthly reports and the annual accounts, the efficiency of an internal audit as a process in examining the LHV Group companies' annual accounts and independence of an audit firm and a sworn auditor representing an audit firm on the basis of law and the compliance of their activities with the requirements of the Auditors Activities Act.

The Audit Committee is responsible for making proposals to the Supervisory Board and providing recommendations for appointment or removal of the audit company, appointment or removal of the internal auditor, prevention or elimination of problems or inefficiencies within the organisation, and compliance with legal acts and good practice.

The Audit Committee consists of a minimum of three members. Members of the Audit Committee are appointed by the Supervisory Board for a term of three years, with the aim of ensuring diversity of competences and independence of committee members. The persons elected to the Audit Committee shall be those, who are sufficiently independent of LHV in order to fulfil their role in an efficient way and at least two of whom shall be experts in accounting, finance or law; also, compliance to the requirements of LHV's internal procedure rules and legislation is important. LHV's employee, member of the Management Board, an internal auditor, a procurator or a person providing the audit auditing service shall not be a member of the Audit Committee. In order to elect a member of the Audit Committee, the candidate's written consent is required. The size of remuneration paid to the members of the Audit Committee is decided by the Supervisory Board of LHV.

The members of the Audit Committee are Kristel Aarna, Tauno Tats and Urmas Peiker (Chairman). The mandate of the Audit Committee is valid until March 31, 2020. More detailed information on the members of the Audit Committee is presented in the Annual Report, section "Corporate Governance of LHV Group". LHV's Audit Committee members are paid a monthly gross remuneration of 500 euros.

Pursuant to the rules of procedure, the Audit Committee gathers for meetings at least on a quarterly basis, but in 2018, the Audit Committee has gathered for meetings on nine occasions.

At seven meetings, representatives of the risk management department gave the members of the Audit Committee an overview of the various risk management topics, bank and group risk exposures, and indicators and measures used to monitor and manage them – as well as the transition process to IFRS 9 and anti-money laundering, management of IT risks and compliance and data protection.

In most of the meetings, the issues raised by the internal audit, above all in connection with various audit reports were discussed in addition to other topics. The internal auditor gave an overview of the concluded audits. The Audit

Committee has reviewed all the reports prepared by the internal audit and discussed the observations made, and the Audit Committee has formulated its views on the observations. In two meetings, the internal audit work plan was discussed. Also, the external auditor participated in three meetings during the year. In February, the external auditor gave an overview of the 2017 annual report audit process and the findings; in October, the 2018 financial audit plan and during the last meeting, of the findings made during the interim audit. During the year, the Audit Committee also confirmed and approved specific additional services provided by an external auditor.

### 3.4 Remuneration Committee

The Remuneration Committee is a body formed jointly by the Supervisory Bodies of LHV and AS LHV Pank for the development, implementation and supervision of the remuneration strategy of the employees and members of the Management Board of the mentioned companies. One of the tasks of the Remuneration Committee is to evaluate the impact of any remuneration-related decision on adherence to the requirements established for the management of risks, own funds and liquidity.

The Remuneration Committee conducts supervision over the remuneration of Management Board members and staff members of LHV, evaluates implementation of the remuneration policy at least on an annual basis and, where necessary, proposes to update the remuneration principles and prepares the related draft resolutions for the Supervisory Board.

The Remuneration Committee consists of a minimum of three members, who shall be elected from among the members of the Supervisory Board. The members of the Remuneration Committee are appointed and removed by the Group's Supervisory Board. A member of the Remuneration Committee shall be appointed for a term of one year. A member of the Remuneration Committee can be re-elected and their mandate extended unlimited times. The persons elected to the Remuneration Committee shall be those, who have sufficient and relevant knowledge, proficiency and work experience in the area of remuneration policy and practices, risk management and control. The size of remuneration payable to the members of the Remuneration Committee is decided by the Supervisory Board.

Members of LHV's Remuneration Committee are Rain Lõhmus, Andres Viisemann and Madis Toomsalu (Chairman) whose mandate is valid until May 21, 2018. More detailed information on the members of the Remuneration Committee is presented in the Annual Report, section "Corporate Governance of LHV Group". No remuneration is paid to the members of the Remuneration Committee.

The Remuneration Committee met once in February 2018, when the Chairman of the Committee was elected, remuneration policy and strategic principles for remuneration, market comparison, critical positions and planned positions for 2018 were reviewed. The committee discussed and made a proposal to the Supervisory Board with regard to the recipients of share options and the related amounts for the results posted in 2017, as well as with regard to the pricing of share options and the share options of resigning staff members. The remuneration system, the goals and salaries of the members of the Management Board, incl. of LHV and itssubsidiaries, and the principles for remuneration of the members of the Management Board and persons who were equal to the members of the Management Board were reviewed.

### 3.5 Risk and capital committee

The Risk and Capital Committee is a functional body of LHV, the task of which is advising the Supervisory Board and Management Board of LHV with regard to risk management principles and risk tolerance, assessing the risks taken by LHV and monitoring implementation of the risk policy within LHV Group companies. The Risk and Capital Committee also carries out supervision of the implementation of risk management principles by the Management Board in accordance with the instructions given by the Supervisory Board, checks that the probability and timing of risk, capital, liquidity and revenue is taken into account in remuneration principles, and that the business model and risk management principles are taken into account in the fees established for customers.

The Risk and Capital Committee shall consist of a minimum of three members, who shall be elected from among the members of LHV Supervisory Board, whereas the committee members shall include the Chairman of LHV Supervisory Board. The persons elected to the Risk and Capital Committee shall be those, who have sufficient knowledge, skills and experience, in order to understand and monitor on a continuous basis the risk management principles and risk tolerance in LHV Group companies. The competence, rights, operating principles and remuneration payable to the members of the Risk and Capital Committee shall be determined by the Supervisory Board of LHV.

Rain Lõhmus (Chairman), Andres Viisemann and Tiina Mõis serve as members of the Risk and Capital Committee, whose mandate is indefinite. More detailed information on the members of the Risk and Capital Committee is presented in the Annual Report, section "Corporate Governance of LHV Group". No remuneration is paid to members of the Risk and Capital Committee.

Four regular meetings of the Risk and Capital Committee were held in 2018, reviewing regular risk reports and loans with high risks. During the meetings, the market risk and liquidity risk assessment principles, RAROC model, as well as the organisation of LHV information security, compliance risks and their management, the new guidelines of the Financial Supervision Authority on the anti-money laundering and terrorist financing and the structure of LHV's AML system and the occurred cases were examined. The IFRS 9 and SREP report and their impact were also reviewed.

### 4. Cooperation of Management Board and Supervisory Board

The Management Board and Supervisory Board work in close co-operation to best protect the interests of LHV. The co-operation is, above all, based on an open exchange of views between as well as within the Management Board and the Supervisory Board.

The Management Board and the Supervisory Board joint their efforts to lay out the objectives and strategy of LHV. In the management of LHV, the Management Board is governed by the strategic instructions given by the Supervisory Board. The Management Board regularly discusses strategic management issues with the Supervisory Board within the framework of an open dialogue. The Board is invited to participate in monthly meetings of the Supervisory Board.

The Management Board regularly informs the Supervisory Board of the key circumstances regarding the activity plans and business activities of LHV, the risks involved and management of such risks.

No conflicts of interests occurred in the financial year 2018; accordingly, no respective improvement measures were applied.

### 5. Disclosure of information

LHV treats all shareholders equally and notifies all shareholders of relevant essential circumstances accordingly, ensuring equal and quick access to the respective information. Information is disclosed in accordance with the rules set forth for publicly traded companies.

LHV contributes actively to the development of good relations with the investor community and to raising the awareness of investors. LHV has set up an investor relations website, making all documents and information available to the shareholders in accordance with the Corporate Governance Recommendations and statutory requirements. LHV is the biggest and the only member of the Baltic market, who publishes monthly financial results, the detailed financial plan of the following year and the five-year financial forecast on its website. The website of LHV shows also the financial calendar of the current and following year, containing the publication dates of the annual report and interim reports and the date of the Annual General Meeting of Shareholders. The disclosed information is available on the website in the Estonian, English and Russian language. LHV also discloses its annual plans and monthly results via the stock exchange announcements.

LHV organises quarterly investor meetings and web-seminars, the summaries of which can be reviewed via the website of LHV. Additional meetings with analysts and presentations and press conferences aimed at analysts, investors or institutional investors are made in accordance with the need and wishes of interest groups. On its website, LHV explains its goals, directions and opinions in terms of possible trends, regulatory or business environment changes. LHV aims at being open to questions, transparent and report of its activities to investors.

LHV's dividend policy is available on LHV's website, stipulating the dividend payment principles, according to which the key precondition for payment of dividends includes external and internal regulatory capital standards, which have to be met in a sustainable manner. LHV may decide to waive dividend payment under the corresponding growth and/or investment plans. Where the preconditions are met, LHV shall pay a minimum of 25 per cent of the shareholders' profit before taxes in dividends, income tax included.

### 6. Financial reporting and auditing

LHV publishes its annual report on an annual basis. The annual report is audited, and approved by the Supervisory Board and confirmed by the General Meeting.

The number of auditors is determined and the auditors appointed by the General Meeting of shareholders. The General Meeting also establishes the procedure for remuneration of auditors. Auditors are appointed for a single audit or for a specified term.

At the end of 2017, the Management Board, in cooperation with the Audit Committee organised a tender for selecting the auditor. Within the tender, LHV met with and requested bids from four major internationally recognised companies. When selecting the auditor, the practical work experience, skills and knowledge, trustworthiness, clear communication and offered terms and conditions of cooperation compared to market conditions and criteria, arising from the specific nature of LHV's business operations were assessed. As a result of the tender, AS PricewaterhouseCoopers was chosen and appointed the company's auditor at the Annual General Meeting of Shareholders held on April, 11, 2018. A two-year contract was entered into with AS PricewaterhouseCoopers for the audit of the financial years 2018-2019. The total sum paid or payable for the services provided by the auditor in 2018 is 170 thousand euros.

During 2018, the auditor has rendered contractual services to LHV consolidation group companies, including audits of the annual accounts of group companies and reviews of the profits disclosed in quarterly financial statements, translation services, tax advisory services, advisory services related to the planned amendments to the Investment Funds Act and other assurance services, which are required to be performed by auditors according to Credit Institutions Act, Securities Market Act and Investment Funds Act. All the services provided were pre-approved by Audit Committee and are permitted services under non-audit EU regulation.

Transactions with related parties are disclosed in Note 24 to the annual accounts.

**Declaration of conformity**

LHV adheres to the Corporate Governance Recommendations, with the exception of the following instructions and recommendations for the reasons stated below:

"*1.3.3. Issuers shall make participation in the General Meeting possible by means of communication equipment (Internet) if the technical equipment is available and where doing so is not too cost prohibitive for the Issuer.*"

Observation of the General Meeting and participation thereof has not been made possible by means of communication equipment. There has been no need, no corresponding requests and no suitable solution for such a facility. Nonetheless, LHV stands ready to ensure participation of shareholders at the General Meeting via secure electronic means (without being physically present at the general meeting), with the corresponding option added to the Articles of Association of LHV.

"*2.2.1. The Management Board shall have more than one (1) member and a Chairman elected by its members.*

*The Management Board or Supervisory Board shall establish an area of responsibility for each member of the Management Board, defining as clearly as possible the duties and powers of each board member. The principles for co-operation between members of the board shall also be established.*

*The Chairman of the Supervisory Board shall conclude a contract of service with each member of the board for discharge of their functions.”*

The Management Board of LHV has one member. LHV is a holding company without any day-to-day operational business activities. Thus, a single member of the Management Board ensures sufficient and comprehensive management of LHV. The major subsidiaries of LHV have management boards consisting of several members.

*2.2.7. Basic wages, performance pay, severance packages, other payable benefits and bonus schemes of a Management Board member as well as their essential features (incl. features based on comparison, incentives and risk) shall be published in clear and unambiguous form on website of the Issuer and in the Corporate Governance Recommendations Report. Information published shall be deemed clear and unambiguous if it directly expresses the amount of expense to the Issuer or the amount of foreseeable expense as of the day of disclosure.*

*The Chairman of the Supervisory Board shall present the essential aspects of the Management Board remuneration and changes in it to the General Meeting. If the remuneration of some of the Management Board members has occurred on a different base, then the General Meeting shall be presented the differences together with the reasons therefore.*"

LHV discloses the total sum of remuneration paid to Management Board members in Note 24 to the annual accounts, highlighting in the Corporate Governance Recommendations Report additionally the number and membership of the persons included in the total sum. LHV does not disclose the remuneration of individual members of the Management Board because this constitutes personal data, the disclosure of which is not unavoidably necessary for evaluation of the operations and management quality of LHV.

"*3.2.2. At least half of the members of the Supervisory Board of the Issuer shall be independent. If the Supervisory Board has an odd number of members, then there may be one independent member less than the number dependent members.*"

Within the meaning of the Corporate Governance Recommendations, only Sten Tamkivi is an independent member of the Supervisory Board of LHV. LHV is in the stage of active development and growth, where it has preferred people of long-term management skills and banking experience as members of the Supervisory Board. These people are also the largest shareholders of LHV. LHV believes that, as members of the Supervisory Board, the largest shareholders are best motivated to contribute to the management of LHV and its development over the long-term horizon. Based on objective and certified data, it still has been confirmed that at least half of the Supervisory Board members are not majority shareholders of LHV, have no right in any way to determine the majority of the

LHV Management or Supervisory Board members and do not exercise control over LHV in any other way, they are not bound with LHV by material business interest, they are not related to a shareholder of LHV who exercises control over LHV, they are staff members of LHV or partners or key personnel of the partner; accordingly, LHV does not consider it necessary to apply any corrective measures and assesses the Supervisory Board of LHV as collectively suitable, including in terms of independence, in the existing membership.

*"Pursuant to subsection 24² (4) of the Accounting Act, a large undertaking whose securities granting voting rights have been admitted for trading on a regulated securities market of Estonia or another Contracting State shall describe in the corporate governance report the diversity policies carried out in the company's Management Board and senior management and the results of the implementation thereof during the accounting year. If no diversity policies have been implemented during the accounting year, the reasons for this should be explained in the corporate governance report."*

LHV has not deemed it necessary to implement a diversity policy, as LHV is governed in the recruitment of staff and management members by the best interests of LHV – the education, skills and previous experience of the person on a gender neutral on non-discriminatory basis and upon need, compliance to statutory requirements.

Tiina Mõis serves as a member of the Supervisory Board of LHV and as a member of the Risk and Capital Committee, and Kristel Aarna as a member of the Audit Committee. Together with the management members, LHV's subsidiaries engage a total of 67 middle-level managers of whom 21 are women.

# Social responsibility in LHV

AS LHV Group (hereinafter LHV) is committed to doing business in a sustainable and socially responsible manner. To do this, on a daily basis we think more broadly than just about LHV's own business concerns. We contribute to Estonia – the local economy, society and community around LHV. We wish to influence the development of the Estonian financial market and banking in a positive direction. Responsibility also manifests itself in our goal to be the best employer to people working for LHV. We are a partner who thinks together with you, understands the need of the opposing party and offers a forward-looking service.

The preparation of the social responsibility report is guided by the principles of international standards as well as the UN Sustainable Development Goals (SDG). In view of sustainable development and social responsibility, we have analysed the following focus areas of corporate social responsibility that are the most important for LHV, and shown the relevant key areas: economic and capital market development, sustainable and responsible business, LHV as the best working environment. The strategic starting points of LHV's social responsibility and sustainable activities as well as responsible management in LHV have also been introduced. Reducing environmental impacts and supporting the social environment are also important.

**Strategic starting points**

LHV's mission is to help raise Estonian capital. Our vision is focused on Estonia, where people and businesses dare to think big, engage in enterprise, and invest in the future.

According to our vision:

- Estonian people and companies dare to do great things, grow boldly and set high goals. Their way of thinking and acting is vast, crossing the boundaries of the state and outdated concepts. Estonian people invest in the Estonian economy.
- Estonian companies are also able to use external labour and new technology, sell their products and services worldwide. They are the biggest employers in Estonia and play an important role in shaping Estonian life and politics. Companies have the opportunity to prefer financial services based on Estonian capital. Estonian products and brands are known in the world for their high quality.
- The Estonian state and people are proud of their companies and entrepreneurs, and LHV is considered to be a "local" with an important role in the Estonian economy and society.

**LHV values are simplicity, support, performance.** We are guided by these values in our actions and in our behaviour as an organisation towards our main stakeholders.

- **Simplicity**

The product range is defined from the customer's point of view; pricing is transparent and easy to understand for the customer; customer service is built on customer comfort and daily behavioural patterns; we are constantly looking for opportunities and technologies to simplify our daily banking.

We talk about things as they are; we strive to make it easy for colleagues to do their job.

Flat organisation and compact team; we focus on these aspects where we can be the best on the market.

LHV's reports are transparent; LHV brand and strategy are easy to understand, relevant and distinct from the market; investments in LHV are easy.

- **Support**

We listen to the customer and consider his/her needs in our solutions; we are easily accessible to the customer; we advise, but do not make decisions for the customer; we treat the customer as an equal partner with whom we have a joint business; if the customer feels that the bank is wrong, we do not justify ourselves but find/seek a solution.

We enable to take risks, make mistakes upon deciding and learn from mistakes; we are open and balanced in giving feedback; we believe that more valuable people are those who have time for their loved ones.

We support those who are committed to their actions. Partnership is central to growing the business of LHV.

- **Performance**

All the products we offer must create clear added value for our customers; when investing our customer's funds, our goal is to achieve a better return than that of the market.

We boldly sell the products we believe in; we exceed customer expectations; we value simple and effective solutions.

We strive for more profitability than foreign banks.

**Responsible management**

We believe that an ethical and appropriate course of action will ensure success in the long term. Therefore, all LHV's managers and employees must behave ethically and responsibly. LHV's Code of Ethics is the foundation of LHV's various policies, internal procedure rules and procedures regulating the specifics of adherence to the Code of Ethics. In our activities, we are guided, above all, by the principle of legality, good practice and common sense.

The internal rules of LHV have been prepared based on the principles of responsibility, among other things. The management principles of LHV are set out in the Corporate Governance Policy and other policies of different areas. The basic principles of governance are better described in the "Best Practice of Corporate Governance".

The risk management and analysis of own activities are essential parts of LHV's responsible management system. In risk management, we take into account credit risks, liquidity risks, market risks, financial crime risks and operational risks.

In December 2018, the credit rating agency Moody's confirmed to LHV Bank an investment grade credit rating of Baa1, confirming a sustainable strong financial profile and its ability to serve the commitments taken.

The LHV management structure is organised in an easy-to-understand manner and includes transparent and understandable lines of responsibility. The Supervisory Board, the Management Board and subdivisions pay attention to risk analysis and mitigation. We have three lines of defence for risk monitoring and risk control. The internal control framework covers well-functioning independent risk management, compliance checks and staff performing audit functions. Management has established the necessary committees to advise on risk management. The company gives a comprehensive overview of the risks in the annual "Risk and Capital Report of AS LHV Group".

The important role of responsible management is coordinated with legislation and sector-specific rules. LHV is precise and cooperative in dealing with regulators and monitoring agencies. We comply with all obligations and accountability arising from the law.

The LHV Group is regulated by about 500 legal acts on nearly 17,500 pages. The rules are constantly changing – there are on average 10-15 changes in the legal framework concerning LHV each month. We have acknowledged the complexity of the legal environment, which is why the Management Board and the Supervisory Board are given regular reviews of the changes. In our business development, we try to find a balance between requirements and opportunities – a high level of awareness and a risk-based approach enable better decisions to be made. LHV's compliance work is focused on the future, we are working on possible changes as early as possible to avoid the later realisation of risks.

**The promotion of the Estonian economy and capital market**

The better the Estonian economy, the higher the quality of life in Estonia is. The role of banking is to be the blood circulation of the economy, to support and promote it through the transfer of capital. LHV involves capital from Estonian depositors and pension collectors, helps to raise it and directs it into the Estonian economy. We are aware of the role of LHV as an influencer in the domestic economy.

LHV's mission is to help raise Estonian capital. Therefore, we apply our strategic strengths – investment and entrepreneurial experience – in order to enable the growth of a modern and viable financial group based on Estonian capital, that helps Estonian companies and people save their money and invest. Internationally LHV is cooperating partner for companies developing financial technology.

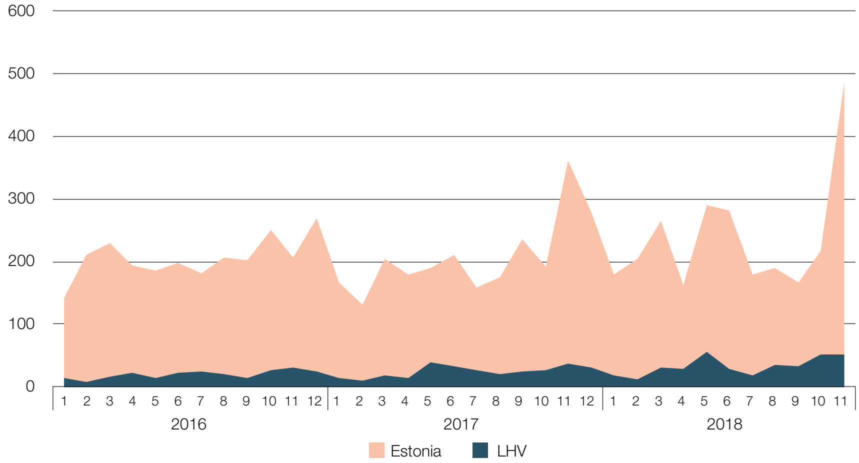
We want to have an impact on Estonian entrepreneurship as well as on the financial behaviour of the people of Estonia towards smarter management through our best market-knowledge, activity and services.

**We promote the Estonian credit market**

As a local financial group, we are aware of our role in promoting the economy. We bring capital from Estonian depositors by directing it to Estonian companies.

In 2018, we upgraded our product portfolio. We added trade financing products. Together with Kredex, we can offer credit to companies that do not have enough guarantee to borrow. In cooperation with the European Investment Fund and the Nordic Investment Bank, we have improved the credit facilities of small and medium-sized enterprises. In addition, in 2018, we launched Student Loan for private customers, and we also started offering insurance products to loan customers.

**Turnover of loans to non-financial corporations by industry (in million EUR)**




Increase in market share of LHV loans, which shows the increase in LHV's role in financing Estonian companies.

The role of LHV in financing business plans of Estonian companies has grown rapidly. We are a caring financial partner for Estonian companies. We have the competence and desire to focus on the plans of Estonian companies and provide them with support in financing these plans. As an intermediary of domestic capital, we are a clear market alternative for companies.

### We contribute to the development of banking

We create and develop our services based on the principles of open banking. We aim to develop the Estonian business environment and B2B cooperation by enhancing partnership, innovation and transparency. We promote innovation and the provision of innovative solutions. For example, the salary payment opportunity brought to the market with the Tax and Customs Board is an initiative created for individual-based microenterprises to reduce paperwork and simplify business operations.

LHV has constructive cooperation and competition with other actors in the financial market. AS LHV Bank (hereinafter LHV Bank) is an active member of the Estonian Banking Association, AS LHV Varahaldus (hereinafter LHV Varahaldus) is an active member of the Association of Managing Companies; additionally, we cooperate with other financial service providers within the framework of the non-profit association FinanceEstonia. We contribute to cross-sectoral issues, such as the sharing of money wisdom in Estonia, law making, the adaptation of regulations, prevention of money laundering and the fight against terrorist financing, and the organisation of payments.

In 2018, Erki Kilu, Chairman of the Board of LHV Bank, was elected Chairman of the Board of the Estonian Banking Association. LHV is represented in the work of all 30 units/workgroups of the Banking Association. Six units are led by LHV.

### We develop financial services through the servicing of financial technology companies

In 2018, we continued the development of a new business line, which is to provide financial intermediaries with service. In March, we opened a branch in the UK to better serve European financial sector innovators.

We are a contributing partner to innovative financial technology companies who often lack the opportunity to find partners in the international banking market. We provide banking services to companies that aim to increase the speed, convenience, and availability of financial services through technological innovation regardless of where they operate.

The development of banking and financial technology is essential as new service providers bring a new level of quality of service to a client, making it more available and affordable. Therefore, we contribute to the growth of competition and help to expand opportunities. We provide banking infrastructure to innovative and technology-intensive companies and are part of the European community of financial technology innovators.

### We export financial services

Through the establishment of the UK branch, LHV has become a financial services exporting company. This brings income from abroad to Estonia, which will benefit our shareholders. Operating on the international market and in London is developing our people who can now work in a more competitive environment.

**We contribute to the development of Estonian capital markets**

The shares of LHV group are listed on the Nasdaq Tallinn Stock Exchange. The company has over 6,000 equity or bond investors. As a publicly traded company, we aim to set an example of how a regulated market can be used to raise capital and, on the other, how to operate openly, transparently, and manage investor relations in the best possible way. We would like as many clients and partners as possible to be shareholders and investors in LHV and to participate in the building of our shared business.

In 2019 Nasdaq gave LHV Group award fot the best investor relation in the Baltics.

For better communication with investors:

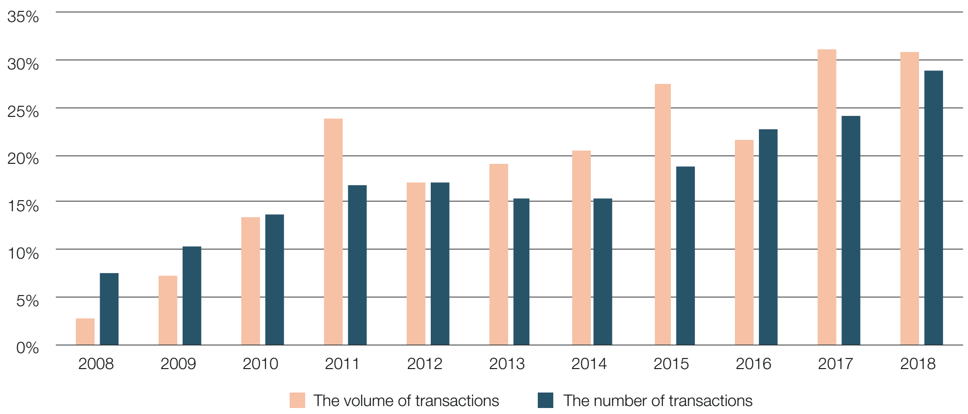
- we will issue a financial forecast for the company for a one-year and a five-year period, so that small investors also have the best knowledge of future plans;
- we publish monthly economic results in addition to quarterly results;
- we organise investor meetings open to all interested parties to comment on the results every quarter;
- we have created an investor.lhv.ee website for investors, which we have built so that the information that is important for investors is equally convenient and easily accessible for everyone.

The goal is to be open to questions, to be transparent and to report to our investors on our activities. We explain our goals to the public. The "Best Practice of Corporate Governance" also provides further details on the fundamentals of information disclosure.

As the institutional brokerage, LHV Bank helps Baltic companies to engage funds from investors. For example, in 2018, we helped AS Tallinna Sadam to carry out an initial public offering to retail investors. We also helped other Baltic companies to raise money from the public market and advised them on important transactions.

LHV Bank is the leading market participant on the Baltic stock exchanges. Our daily brokerage activities as well as our efforts to set an example, contribute to the functioning of Estonian capital markets. In 2019, LHV Bank received the "Best Stock Exchange Member of the Year" award of the NASDAQ Baltic Stock Exchanges. In terms of trading activity of exchange members, we have become the market leader in the Baltics, both in terms of volume of transactions and the number of transactions. We prepare and publish analyses about stock companies in the Baltics. We are market makers for 9 publicly traded companies.

**LHV market share by year**




Development of LHV brokerage market share in the Baltic markets (Baltic main list and additional list in shares; First North list)

**Development of Estonian companies through pension fund investments**

LHV pension funds play an increasingly important role in financing Estonian companies, the aim of which is to become Estonia's most important institutional investor. LHV Varahaldus increases the number of pension fund customers and the volume of assets which are used for investments.

LHV's pension funds have invested a considerable portion of the clients' pension assets in Estonia and the Baltic countries, in Estonian real estate, enterprises and forest. In 2018, LHV Varahaldus made positive investment decisions in Estonia in the amount of 150 million euros (in 2017, the amount was 170 million euros). We invested in residential real estate as an institutional investor to develop the local rental market. We also invested in the growth of domestic Alexela to become the largest gas station chain in Estonia. In 2018, we created a new pension fund LHV Pensionifond Eesti, which only invests in Estonia.

Like before, we also developed the Estonian capital market as new investment instruments were created as a result of investments. We search for and analyse local investment opportunities. We also create such opportunities ourselves.

After the implementation of changes in pension fund investment conditions in September 2019, LHV's actively managed pension funds aim to earn 7% return per year to be able to earn success fees with all the actively managed funds.

**We grow money wisdom and investor knowledge**

As a leader of the investor community, LHV takes responsibility for sharing money wisdom and advancing investor education. We contribute through the following activities:

- We organise regular, free-of-charge "Investor School" seminars for those interested in investing. In 2018, the "Investment School" seminars were attended more than 4,700 times (3,400 in 2017). We also continued organising "Investor Meets" seminars, allowing heads of publicly traded companies to meet investors.
- We organise the yearly stock market game “Ärihai”. In 2018, there were 2 600 investment enthusiasts who took part in the game (the number of participants was 818 in 2017). We had a special focus on young people.
- We cooperate with other Estonian financial institutions and participate in money wisdom promotion month organised by the Estonian Banking Association.
- We have set up and we manage a library of investment and economic literature. Our libraries in Tallinn and Tartu hold about 1,000 different publications that are available to lend to our clients.
- LHV manages the LHV financial portal and the forum set up for discussing investment-related subjects and sharing information. We create content that would interest Estonian investors.
- In 2018, we launched a micro-investment product suitable for beginning with investments.
- Since 2007, we have published the free-of-charge journal “Investeeri”, addressing various topics related to entrepreneurship and investing. In 2018, the journal published four editions.
- As a contributor, we helped launch a new economic news portal Rahageenius, which is designed primarily to make economic content accessible and understandable to ordinary consumers.

Our goal is to continue to actively share investment knowledge and to increase the number of investment seminar visitors to 5,000 per year.

**Sustainable business**

LHV wants to do its daily business in a way that is sustainable in the long run and based on responsible decisions. We are not only concentrating on maximising short-term profits, but also keep in mind the long-term, mutually beneficial relationships with the market and customers.

**Keeping a cohesive and supportive partnership with customers**

For our clients, we are a partner who is reflective, understands the needs of our clients, and offers the most advanced banking services and the best service. In relations with all stakeholders, we consider partnership, honesty, goodwill, engagement and transparency, and at the same time trust to be important. The purpose of adherence to the principle of social responsibility is to create long-term value for LHV's counterparties, and focus on the customer and his/her needs in our business activities.

We want to service our clients and communicate with them soundly, kindly and politely. Our respect for our clients is reflected in understanding the client's needs, in our responsibility, in our availability to our clients as well as in our effective administration.

We organise regular internal training sessions and the necessary certification to provide the best customer service. We have developed a customer service textbook to provide the best service. In February 2018, we organised an in-house service month for LHV, where we paid attention to good service and organised evaluations more than usual. We have taken various steps with client engagement.

- In 2018, Euromoney recognised LHV Bank as the best bank in Estonia. This world's leading economic magazine also recognised LHV's private banking service as the best in Estonia.
- According to the research company DIVE, LHV's service was the best in the Estonian banking sector in 2016 and 2017, and we managed to maintain an excellent level in 2018 (result 91% of maximum, while our goal was >90%).
- Over the year, we organised internal mystery shopping events, the result of which was very good, averaging 90% (the target was 95%).
- During the year, we asked 16,770 LHV customers who contacted the LHV customer support for feedback on our service. 40.6% of respondents gave their feedback. As a result, more than 90% (target >90%) of customers were satisfied with the service and solving their issue (6,166 respondents were positive on the service and 643 respondents said the service was deficient or they were dissatisfied).

All client complaints and proposals are registered and taken into account when organising the bank's work. In 2018, LHV Bank registered 338 customer complaints (309 in 2017). Complaints were solved efficiently, transparently and quickly. The customers' complaints and suggestions should be treated as important feedback which draws our attention to the shortcomings of our products, services and customer service, and to enhance quality accordingly.

We have organised client satisfaction surveys and developed our services in line with our clients' wishes. We have created convenient and diverse communication channels for communication. The official channels include phone, e-mail and live chat; information and feedback can be shared on social media channels and through the LHV financial portal. The attraction and retaining of our cooperation partners is based on the same general principles as client communication.

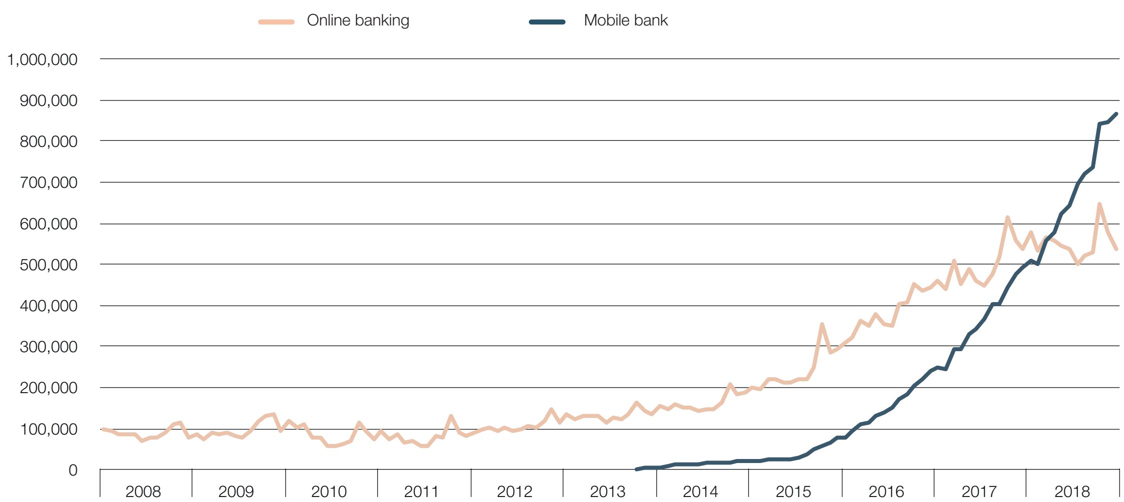
We conduct regular surveys to understand the community's mindset and LHV's role in society. We also participate in analysis and research projects across the banking sector. In 2018, LHV conducted a Brand Survey to better understand the reputation of LHV in society and to map expectations towards LHV. The survey confirmed that:

- Awareness of LHV as a provider of financial services is high and has improved compared to the past (97% of assisted recognition; goal to improve the result of >87%);
- Satisfaction of LHV pension fund customers with their pension fund manager and collection result is high (62%; 73% in 2016);
- Satisfaction with LHV Bank is higher than for other banks (82% do not see the need for changing their bank services provider);
- Recommendation index in the sector is high (55);
- LHV Bank is rather perceived as a local, simple, modern, customer-centred, reliable and important bank.

### We provide accessible and affordable electronic service

When providing services, LHV deliberately focuses on electronic service channels, which helps customers to access services as easily as possible, saving the environment, resources, manpower, etc. Also in 2018, we prioritised the development of electronic service channels. In addition to online banking, the mobile bank channel has grown significantly both in terms of importance and user activity.

**LHV online banking and mobile bank usage activity by login**



Electronic channels provide significant added value to target customers. LHV customers can use services, sign agreements, and make transactions by using electronic identification and signing possibilities. For customers, this reduces the time spent, helps save on transport, etc.

**We offer quality services that meet the needs of the target group**

We focus on active and independent customers with an enterprising frame of mind. LHV wants to be the best financial services provider for private individuals who are accumulating and investing in financial assets and companies in need of financing. LHV Bank and LHV Varahaldus have created the products offered to their customers in view of the long-term needs of the customers. LHV Bank has focused on providing private customers and small and medium-sized enterprises with the best banking services. The main activity of LHV Varahaldus is offering the best pension funds to provide our customer with a long-term pension savings service.

Through the years, LHV has developed almost all the financial products needed by their customers to help them manage their money. We do not charge excessive service fees from our customers, the pricing is clear and transparent. For example, LHV Pank offers free European payments to their customers.

At the end of the year LHV Pank joined the real time euro payment system, which makes settlements more convenient for the customers and enables the development of new financial services.

In 2018, the selection of retail financing products offered to companies was supplemented. We improved our corporate loan options. We improved our electronic communication channels, ATM network and access to cash and launched LHV Youth Bank at the end of August.

LHV Youth Bank was the first time for us to focus on the young segment. These are clients we wish to engage in the long term by offering support to them; by means of help and guidance we can provide our new generation of clients with the necessary financial knowledge and experience to make them more knowledgeable in money matters in the future. Most of our services offered to young people are free. Youth Bank started with LHV Youth Card offering various discounts and micro investment, which makes it easy to start saving and investing. We also started offering student loans for young people to finance their education.

In order to contribute to the health of our young clients, in autumn we started our cooperation with the health app Sweatcoin.

LHV Varahaldus offers a wide selection of pension funds to the customers. In 2018, the pension fund LHV Pensionifond Eesti was added to the selection.

**We respect regulations and ethics**

**Responsible loaning** – LHV cares about the business and living environment and strives to minimise any negative impacts of its activities and processes. LHV's credit policy stipulates that LHV makes it their goal to operate in a socially responsible manner, setting an example to both its employees and the general public. All credit decisions are governed by the principle that LHV does not finance counterparties whose activities are liable to cause disproportionate damage to the environment or do not comply with the principles of social responsibility. When financing payment transactions, we make sure that they are not in violation of the tax law in their intent or meaning.

LHV Bank is governed by the responsible lending principle.

We make sure that loan product advertising targeting our consumers is responsible and balanced and does not encourage the customer to make financial decisions that may prove harmful to them. This is also evident in LHV's high credit quality. When engaging in loan relations, the client can assess the suitability of the loan or credit relationship for their loan interest and financial situation and consider the risks.

**Prevention of money laundering and terrorism** – We are exemplary in respecting all requirements for identifying clients and the parties related thereto by understanding their activities. LHV Pank takes a risk-based approach in its operations and makes it a principle to know its customers. This means the requirement of identifying the customers, knowing the origins of their assets and, in certain cases, wealth, and understanding the reasoning behind the formation of business relations. We also monitor our clients' activities to identify operations raising a suspicion of money laundering or terrorist financing. LHV's client acceptance principles define what kind of clients LHV Pank does not wish to engage in client relations with.

LHV Pank enforces international financial sanctions and does not offer services to entities subject to them.

LHV Pank pays particular attention to the clients who offer financial services to their own clients. When providing services to such clients, the same due diligence measures as those used in the provision of correspondent banking services are implemented.

We have continued to increase our anti money laundering and terrorist financing team, which is active in both LHV Pank as well as the bank's external initiatives. LHV's employees are leading both AML and compliance control working groups in the Estonian Banking Association. Through the said working groups, but also other channels, we provide our input to the legislative process, help to develop good banking practices, and are active in the development of a whole anti money laundering and terrorist financing system. For example in 2018, through the Estonian Banking Association we participated in the drafting of AML recommendations for the Ministry of Economic Affairs and Communications, development of E-residence in various working groups, drafting the shared due diligence measures for the banking sector, etc.

We also engage in active cooperation with our supervisory bodies. In 2018, we integrated the FICO Tonbeller Siron information system to facilitate anti money laundering and terrorist financing monitoring and Accuity Compliance Link for the online screening of payments into our systems.

**Ethical and honest business which respects human rights** – we believe that being ethical, honest, corruption-free and law-abiding is the key to long-term success. This is why all the executives and employees must follow the guidelines laid down in LHV's principles of ethics and ensure that the agreed values are followed in real-life situations. LHV's new employees will be acquainted with all the important principles when they assume their new position.

In all our operations we take care to respect international norms, human rights, data protection regulations, legal acts and rules applicable in the financial sector. LHV's main site of operations is Estonia, where the generally recognised basic human rights are protected, and LHV's practices in this are no different from the general practices of the banking market. We make sure that basic rights are protected both within LHV as well as in our relations with third parties.

In our daily work and interactions with our partners we are responsible, professional, honest and respectful. We acknowledge that our actions have an impact. We base our actions on our values with both LHV's internal target groups as well as internal parties.

At LHV we do not only follow the law by its word, but also intent. We strive to understand the reasoning and background of norms. Taking advantage of legislative gaps is not considered acceptable at LHV.

**Honest competition** – when communicating with competitors and supervisory authorities, we keep in mind that all market participants and supervisors pursue market stability and endeavour to remain trustworthy in the eyes of the customers. We are accurate, honest and respectful towards our competitors, and avoid talking poorly of them in any way. We abide by the principles of fair competition, and only use legal and ethical means for gaining a competitive edge. Any agreements or concerted practices between market participants, which have the restriction of competition as their object or effect are prohibited.

**Honest and transparent marketing and communication** – LHV Bank abides by the generally accepted marketing principles and does not use information that is inaccurate or attacks their competition in their advertising. We ensure that any information provided to customers, including all marketing materials, is factually correct, easily understandable and competent, and draws sufficient attention to the potential risks and costs related to the service. LHV has compiled their advertising content guidelines. LHV has internal control measures to make sure that their advertising is in compliance with the law and its internal regulations.

Any stock exchange announcements, press releases and statements published by LHV are accurate and timely, without distorting any facts. Our statements aim to give a true and fair view of LHV Bank's financial position, economic results and cash flows. We comment and provide information on topics related to LHV's business activities. In 2018, we informed the public with 48 stock market announcements and 37 press releases.

**Protection of a banking secret** – LHV's operations are based on the trust of our customers, supervisory authorities and the society. Clients' assets and personal information are reliably protected at LHV. We treat all the information related to our customer, including the fact that they are our bank's customer, as a banking secret. LHV's employees are not permitted to disclose client-related information treated as a banking secret to persons who are not entitled to such information.

LHV's staff members apply measures to ensure that customer data are kept confidential, including legally required security measures for the protection of personal data and prevention of the processing of personal data by unauthorised persons.

In 2018, the position of Head of Information Security was formed at LHV Pank and even more focus than before is being put on information security. We have also taken the direction of informing our clients and the public in matters related to information security. In the Banking Association, we engage in cooperation with other banks in presenting topics related to information security.

**Protection of insider information** – as a publicly traded company, LHV treats all of its investors equally. In compliance with the Estonian stock exchange legislation, the European Union legislation and Nasdaq Tallinn Stock Exchange rules, we have established the rules for the management of insider information, that all the employees and executives of LHV must follow. The rules lay down the principles for the maintenance and disclosure of insider information and prohibitions and restrictions in making transactions with the Group's securities.

As a publicly traded company, LHV has also heightened expectations towards its employees' personal transactions. In order to protect LHV's trustworthiness, the company has established rules for personal securities transactions, which rule out conflicts of interest and making transactions using information not available to the public.

Regulations for the management of a conflict of interest are in place for avoiding and managing conflicts of interest.

**We strive to guarantee employee satisfaction**

There are more than 380 people working at LHV who form a community that is one of the company's most important assets. LHV's goal is to be the best employer so that each person working in the company may contribute to the development of the company and feel the importance of their contribution. We strive for an honest, open and supportive internal climate.

In the selection of LHV's employees and executives, LHV is always guided from LHV's best interests and therefore makes the choices in a gender neutral and non-discriminatory manner based on the person's education, skills and prior experience and, if necessary, requirements arising from the respective legislation. LHV has not found it necessary to implement any diversity policies. Also counting the Management Board, the companies of LHV employ 67 executives of whom 21 are women.

**Satisfaction and regular feedback**

We have developed various measures to get feedback from our employees and encourage in-house communication.

Every two years, we hold employee satisfaction surveys. In 2018, the satisfaction survey was filled in by 290 employees, which is 79% of the whole staff. The overall result of the survey was 6.2 points (out of 7). We have fulfilled our goal of improving this score. It was 6.0 points in 2016, 5.8 points in 2014 and 5.7 points in 2012 and 2010. Outstanding scores of 6.4 points (out of 7) were given to direct supervisors. The survey confirmed that our human resource policies are moving in the right direction and in general, employee satisfaction continues to soar.

When comparing the answers of men and women, it is clearly evident that the results are similar. There is no difference between how men and women perceive the situation in the company. Looking by age brackets, the results are similar, although younger people tend to give higher scores. By seniority, satisfaction is highest among the newest employees.

The overall recommendation index reaches a record high of 71%. In 2016, the result was a solid 62%, but the goal was to improve it further. 222 of the employees rated the question of whether they would recommend LHV to their friends as a good employee with 9 or 10 points out of 10. A growing enterprise has room for improvement in the field of internal communication and the flow of information, which was also revealed in the survey. We will focus on it more in the next few years.

Satisfaction was also evident in the voluntary staff turnover, which in 2018 was low at 7% (9% in 2017).

We take employees' suggestions into account in our management decisions. To make changes within the company, we organise workshops for our employees. We also hold various workshops and courses to develop our executives and get feedback from them.

Employees can give their input and contribute to the development of the company at meetings and strategy days. We collect feedback from new employees at the end of the probationary period and take it into account in the organisation of their future work.

Becoming and being an owner of LHV is favoured. There is an option programme available for executives and key employees. It is a long-term performance pay programme (at least 4 years in the case of executives) integrating the interests of the owners and the performance pay receivers, enabling one to focus on long-term outcomes while bearing all the risks in mind.

Our goal is to give the employees of LHV the best possible work environment, which takes the employees' needs into account.

**Contributions to development and health**

We contribute to the individual development of our people. LHV's training department is guided by a person-centred approach, based on the personality needed to improve skills, motivation, qualifications, including providing training, teaching materials etc. If necessary, we offer professional rotation within LHV. We have developed a new internal training programme, including thorough training for new employees and language courses. In 2018, changes were made in the new employee training programme, for it to be more easily comprehensible, focusing more on the most important basics and also covering unguided communication as a social component.

The professional requirements and instructions are documented in the internal procedure rules that are available to everyone. We have devised a special development programme for executives.

LHV contributes to the physical and mental health of its employees. We support the sports initiatives of our employees (football, basketball, volleyball, squash, tennis, badminton, public sports events) and offer sporting benefits (sports expenses, rehabilitation). In 2018 the quarterly sports and health benefits were increased to 100 euros. The usage rate of the benefits in the 2nd half of 2018 was as follows: AS LHV Pank 76%; AS LHV Varahaldus 80%; AS LHV Finance 70%.

We reimburse dental care. We provide vaccinations. LHV has an outstanding occupational health package. LHV belongs to a network of employers engaged in promoting their employees' health. We take into account occupational health considerations using eye strain relieving computer screens, 100% adjustable chairs and desks, and, if necessary, provide people with assistive devices. In the office, we have healthy and natural carpeting with high wool content.

A work environment council operates at LHV, including the representatives of both the employer and the employees.

We emphasise occupational safety. All worksites have undergone risk analysis. On each floor of the offices, there are first aid assistants who have received the required training, and those responsible for fire safety.

In April we had a Health Week, promoting healthy lifestyle habits among our employees and holding courses and joint events.

More than before, LHV has been focusing on the mental health of employees. All employees of LHV have the option of using a therapist's service for counselling in personal or work-related issues. In addition to the above, we have started with mindfulness courses.

For the second year in a row, we successfully carried out our Winter Office project, enabling 130 employees to spend a bit of time working remotely in Portugal. Employees were granted workstations and part of their transportation costs was covered. The winter office has received positive feedback and the project will continue next year.

We try to take the personal needs of people working at LHV into consideration. For example, we can accommodate students with part-time working hours or, if possible, flexible working hours. Every tenth employee has started at LHV as an intern – we offer students the opportunity to continue working for us. In 2018 we hosted 15 interns, of whom 8 continued to work at LHV. Students also have the opportunity to be a job shadow at LHV.

To ensure a good work-life balance, we value family life: upon the birth of a child, fathers are also granted 15 days' leave, employees receive monetary bonuses when their child starts school and can work reduced hours on their child's birthday and get a day off work for marriage. We offer a childbirth allowance and a death grant. We have special events for employees with families: family days, children's Christmas party. In our remuneration policy, we are objective and unaffected by the employee's person. If required for the positions, we always check compliance with the entry criteria.

Our goal is increasing the job satisfaction of LHV's employees and motivating them, raising their competence (knowledge, skills, experience and capacity), guiding the development of staff satisfaction and fostering the feelings of solidarity and pride.

**Preservation of the natural environment**

The impact of LHV's activity on the natural environment is limited due to the organisation of our operations. LHV Group companies are located in two places of business, in the centre of Tallinn and Tartu. In 2018, an office in London was added to our work sites. LHV is also renting a smaller office space in Telliskivi Street in Tallinn. At the moment, their importance is rather small.

As a matter of principle, we do not manage a broad office network. We also offer our services through electronic channels, which, among other things, reduces the impact of our activities on the natural environment.

In recent years, we have made several decisions in the direction of having less environmental impact. In this way, we have reduced the use of paper in LHV's activities (the transition to paperless document management, the provision of electronic customer agreements and the so-called FollowMe Printing System solution). We separate the waste paper from other household waste. We have also replaced the use of water machines in our offices with drinking tap water. To reduce the transport volumes, LHV has developed solutions for holding meetings through electronic communication, for example, administration between Tartu and Tallinn is mostly carried out by electronic means.

The office opened in 2018 in the United Kingdom is located in London in the newly opened White Collar Factory building, which has been constructed by environmental guidelines, using passive energy and smart energy-conservation solutions. It is also a work environment putting focus on employee welfare, granting opportunities for exercise and a healthy lifestyle.

Due to the internationalisation of LHV's business operations, work-related international travel increased at LHV in 2018. In total, LHV's employees travelled 1,028,247 flight kilometres on 821 planes.

### Supporting the social environment

In addition to the aforementioned activities supporting the Estonian economy and society, LHV does its best in supporting endeavours and initiatives contributing to the growth of Estonian society. In our sponsorship projects, we prefer long-term and substantial cooperation. We are willing to contribute to the development of Estonian society and to the realisation of innovative ideas that help to make life in Estonia better.

### Estonian culture and society

Estonian Music Days – from 2016, we are supporting Estonia's oldest music festival, and presenting Estonia's new musical composition award Au-tasu. In 2018, the award for the best new work went to Erkki-Sven Tüür.

**Enn Soosaar Foundation – with LHV's support, the awarding of an annual prize – named in honour of Enn Soosaar – "Ethical Essay-Writing Prize" began in 2012.** In 2018 the award went to Marju Lepajõe.

Intsikurmu Music Festival in Põlva – we supported the music festival for the third time.

We were the main sponsor for the student conference "Awesome day at school" with 1,300 participants.

### Sport and a healthy lifestyle

The Estonian Football Association – LHV Pank has been the main sponsor of the Association and the Estonian National Team since 2010. In addition, we have created the support system of LHV's Football Card that earnt a record amount of 79 766 euros for Estonian football clubs in 2018. The Football Card system enables us to unite and maintain the football community.

Estonian Optimist Class Association – we have helped to ensure the sustainability of Estonian sailing for more than ten years. The activities of the association were revived in 2007 when active work started again, sparking interest in sailing among children.

Running events – we supported organising LHV's health run and walk series. Health Run is a unique event series in Estonia, lasting from spring to autumn and giving the chance to challenge oneself on different terrains. This year's series had 17 different running tracks, 3 of them completely new. This year there were 268 teams participating in the series and 211 runners competing individually. The 1,559 participants managed to cover 101,628 kilometres in total.

We organise a corporate football event, the LHV Cup. It took place for the second time in 2018 with 100 amateur athletes participating.

### Economy and Entrepreneurship of Estonia

Estonian Entrepreneur of the Year competition – we have been one of the main sponsors of the Estonian Entrepreneur of the Year competition since 2012. In 2018, the entrepreneurs of the year were Martin and Markus Villig.

The Gazelle movement – LHV is the sponsor of the Gazelle movement. The movement supports and acknowledges rapidly growing Estonian companies.

Tallinn Restaurant Week – we have been supporting the initiative of the Estonian Restaurant Association since its beginning in 2011. Tallinn Restaurant Week aims to popularise and promote eating out as an opportunity to obtain a cultural experience and socialise.

We supported the organising of the tech conference Latitude59 for the second time in a row.

We issued export grants in cooperation with Tallinn Creative Incubator. LHV's award was earnt by OÜ Triibuvineer.

We support many smaller local initiatives with our knowledge, LHV's thematic gifts, advice and performances by our people. We participate in fairs, cooperate with universities, also within the framework of internship programmes. We belong to the Estonian Association of Information Technology and Telecommunications, the Estonian Chamber of Commerce and Industry and the Estonian Employers' Confederation. We also consider it essential to help Estonian producers and companies through our procurement and cooperation relations. LHV knowledgeably uses the products and services of Estonian entrepreneurs (from office coffee to Estonian design and work clothes).

# CONSOLIDATED FINANCIAL STATEMENTS

## Consolidated statement of profit or loss and other comprehensive income

| *(in thousands of euros)* | Note | 2018 | 2017 |
|---|---|---|---|
| **Continuing operations** | | | |
| Interest income | | 45 622 | 35 494 |
| Interest expense | | -7 471 | -5 133 |
| **Net interest income** | 5,7 | **38 151** | **30 361** |
| Fee and commission income | | 32 844 | 26 402 |
| Fee and commission expense | | -7 799 | -5 413 |
| **Net fee and commission income** | 5,8 | **25 045** | **20 989** |
| Net gains from financial assets measured at fair value | 5, 11,12 | 379 | 714 |
| Foreign exchange rate gains/losses | | 64 | 265 |
| **Net gains from financial assets** | 5 | **443** | **979** |
| Other income | | 905 | 36 |
| Other expense | | -43 | -182 |
| Staff costs | 9 | -15 756 | -12 991 |
| Administrative and other operating expenses | 9 | -16 387 | -14 407 |
| **Profit before credit losses** | | **32 358** | **24 785** |
| Impairment losses on loans and advances | 5,13 | -4 879 | -3 584 |
| **Profit before income tax** | | **27 479** | **21 201** |
| Income tax expense | 5,6 | -3 614 | -951 |
| **Profit from continuing operations** | 5 | **23 865** | **20 250** |
| **Profit from discontinued operations** | 26 | **3 324** | **1 927** |
| **Profit for the year** | | **27 189** | **22 177** |
| **Other comprehensive income/loss:** | | | |
| Items that may be reclassified subsequently to profit or loss: | | | |
| Changes in the fair value of available-for-sale financial assets | 11a | 0 | 76 |
| Changes in the fair value of debt instruments measured at FVOCI | 11b | -36 | 0 |
| Items that will not be reclassified to profit or loss: | | | |
| Net gains on investments in equity instruments designated at FVOCI | 11b | 78 | 0 |
| **Total profit and other comprehensive income for the year** | | **27 231** | **22 253** |
| **Total profit attributable to:** | | | |
| Owners of the parent | | 25 237 | 19 603 |
| Non-controlling interest | | 1 952 | 2 574 |
| **Total profit for the year** | 5 | **27 189** | **22 177** |
| **Total profit and other comprehensive income attributable to:** | | | |
| Owners of the parent | | 25 279 | 19 679 |
| Non-controlling interest | | 1 952 | 2 574 |
| **Total profit and other comprehensive income for the year** | | **27 231** | **27 232** |
| Basic earnings per share (in euros) | 25 | 0.97 | 0.77 |
| Diluted earnings per share (in euros) | 25 | 0.96 | 0.75 |
| Basic earnings per share (in euros) from continuing operations | 25 | 0.85 | 0.69 |
| Diluted earnings per share (in euros) from continuing operations | 25 | 0.83 | 0.68 |

Notes on pages 53 to 146 are an integral part of the consolidated financial statements.

## Consolidated statement of financial position

| *(in thousands of euros)* | Note | 31.12.2018 | 31.12.2017 |
|---|---|---|---|
| **Assets** | | | |
| Due from central bank | 10 | 639 862 | 920 714 |
| Due from credit institutions | 10 | 25 791 | 26 312 |
| Due from investment companies | 10 | 17 005 | 14 186 |
| Available-for-sale financial assets | 11a | 0 | 775 |
| Equity instruments at fair value through other comprehensive income | 11b | 298 | 0 |
| Financial assets at fair value through profit or loss | 12 | 46 856 | 55 859 |
| Loans and advances to customers | 13 | 918 761 | 732 043 |
| Receivables from customers | 14 | 3 721 | 9 800 |
| Other financial assets | 15 | 2 936 | 2 289 |
| Other assets | 15 | 1 651 | 1 516 |
| Tangible assets | 16 | 1 135 | 1 421 |
| Intangible assets | 16 | 15 470 | 4 327 |
| Goodwill | 6 | 3 614 | 3 614 |
| **Total assets** | **5** | **1 677 100** | **1 772 856** |
| | | | |
| **Liabilities** | | | |
| Deposits from customers and loans received | 17 | 1 443 782 | 1 542 929 |
| Financial liabilities at fair value through profit or loss | 12 | 11 | 2 |
| Accounts payable and other liabilities | 18 | 24 644 | 71 070 |
| Subordinated debt | 20 | 50 900 | 30 900 |
| **Total liabilities** | 5 | **1 519 337** | **1 644 901** |
| | | | |
| **Equity** | | | |
| Share capital | 21 | 26 016 | 25 767 |
| Share premium | 21 | 46 653 | 46 304 |
| Statutory reserve capital | 21 | 3 451 | 2 471 |
| Other reserves | 11,21 | 2 090 | 1 449 |
| Retained earnings | | 75 430 | 44 071 |
| **Total equity attributable to owners of the parent** | | **153 640** | **120 062** |
| Non-controlling interest | 6 | 4 123 | 7 893 |
| **Total equity** | | **157 763** | **127 955** |
| | | | |
| **Total liabilities and equity** | | **1 677 100** | **1 772 856** |

Notes on pages 53 to 146 are an integral part of the consolidated financial statements.

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## Consolidated statement of cash flows

| *(in thousands of euros)* | Note | 2018 | 2017 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Interest received | | 45 007 | 34 215 |
| Interest paid | | -6 781 | -4 496 |
| Fees and commissions received | | 32 844 | 26 400 |
| Fees and commissions paid | | -7 799 | -5 412 |
| Other income received | | 891 | -133 |
| Staff costs paid | | -14 647 | -11 861 |
| Administrative and other operating expenses paid | | -13 415 | -13 107 |
| Income Tax | | -3 070 | -951 |
| **Cash flows from operating activities before change in operating assets and liabilities** | | **33 030** | **24 655** |
| | | | |
| **Net increase/(decrease) in operating assets:** | | | |
| Net increase/(decrease) in financial assets held for trading at fair value through profit or loss | | 0 | 278 |
| Net increase/(decrease) in financial assets at fair value through profit or loss | | -115 | 0 |
| Loans and advances to customers | | -199 259 | -190 320 |
| Mandatory reserve at central bank | | 1 094 | -7 639 |
| Security deposits | | -647 | -1 348 |
| Other assets | | -597 | 177 |
| **Net increase/(decrease) in operating liabilities:** | | | |
| Demand deposits of customers | | -105 458 | 785 454 |
| Term deposits of customers | | -9 316 | -25 052 |
| Loans received | | 16 250 | 6 000 |
| Repayments of loans received | | -722 | -779 |
| Financial liabilities held for trading at fair value through profit or loss | | 8 | -207 |
| Other liabilities | | -38 413 | 45 217 |
| Discontinued operations | | -121 | -5 330 |
| **Net cash from/(used in) operating activities** | | **-304 415** | **631 106** |
| | | | |
| **Cash flows from investing activities** | | | |
| Purchase of tangible and intangible assets | 16 | -3 450 | -1 368 |
| Disposal of subsidiaries, net of cash disposed | 6 | 5 046 | 0 |
| Proceeds from disposal and redemption of investment securities at fair value through other comprehensive income | 11 | 520 | 100 |
| Net changes of investment securities at fair value through profit or loss | 12 | 9 473 | 19 962 |
| **Net cash from/(used in) investing activities** | | **11 589** | **18 694** |
| | | | |
| **Cash flows from financing activities** | | | |
| Paid in share capital (incl. share premium) | 21 | 598 | 823 |
| Paid dividends | 21 | -5 295 | -3 804 |
| Subordinated loans received | 20 | 20 000 | 0 |
| **Net cash from financing activities** | | **15 303** | **-2 981** |
| **Effect of exchange rate changes on cash and cash equivalents** | | **64** | **254** |
| **Net increase/(decrease) in cash and cash equivalents** | | **-277 459** | **647 073** |
| Cash and cash equivalents at the beginning of the year | 10 | 945 837 | 298 764 |
| **Cash and cash equivalents at the end of the year** | 10 | **668 378** | **945 837** |

Notes on pages 53 to 146 are an integral part of the consolidated financial statements.

# Consolidated statement of changes in equity

| *(in thousands of euros)* | Share capital | Share premium | Statutory reserve capital | Other reserves | Accumulated deficit/ retained earnings | Total | Non-controlling interest | Total equity |
|---|---|---|---|---|---|---|---|---|
| **Balance as at 01.01.2017** | **25 356** | **45 892** | **1 580** | **1 244** | **28 335** | **102 407** | **5 319** | **107 726** |
| Paid in share capital | 411 | 412 | 0 | 0 | 0 | 823 | 0 | **823** |
| Transfer to statutory reserve capital | 0 | 0 | 891 | 0 | -891 | 0 | 0 | **0** |
| Dividends paid | 0 | 0 | 0 | 0 | -3 804 | 0 | 0 | **-3 804** |
| Share options | 0 | 0 | 0 | 129 | 828 | 957 | 0 | **957** |
| Profit for the year | 0 | 0 | 0 | 0 | 19 603 | 19 603 | 2 574 | **22 177** |
| Other comprehensive income | 0 | 0 | 0 | 76 | 0 | 76 | 0 | **76** |
| Total profit and other comprehensive income for 2017 | 0 | 0 | 0 | 76 | 19 603 | 19 679 | 2 574 | **22 253** |
| **Balance as at 31.12.2017** | **25 767** | **46 304** | **2 471** | **1 449** | **44 071** | **120 062** | **7 893** | **127 955** |
| Changes in initial application of IFRS 15 (Note 2.1 (a)) | 0 | 0 | 0 | 0 | 10 617 | 10 617 | 0 | **10 617** |
| **Restated balance as at 01.01.2018** | **25 767** | **46 304** | **2 471** | **1 449** | **54 688** | **130 679** | **7 893** | **138 572** |
| Paid in share capital | 249 | 349 | 0 | 0 | 0 | 598 | 0 | **598** |
| Disposal of subsidiary | 0 | 0 | 0 | 0 | 0 | 0 | -4 550 | **-4 550** |
| Transfer to statutory reserve capital | 0 | 0 | 980 | 0 | -980 | 0 | 0 | **0** |
| Dividends paid | 0 | 0 | 0 | 0 | -4 123 | -4 123 | -1 172 | **-5 295** |
| Share options | 0 | 0 | 0 | 599 | 608 | 1 207 | 0 | **1 207** |
| Profit for the year | 0 | 0 | 0 | 0 | 25 237 | 25 237 | 1 952 | **27 189** |
| including changes on initial application of IFRS 9 (Note 2.1 (a)) | 0 | 0 | 0 | 0 | -731 | -731 | -18 | **-749** |
| Other comprehensive income | 0 | 0 | 0 | 42 | 0 | 42 | 0 | **42** |
| Total profit and other comprehensive income for 2018 | 0 | 0 | 0 | 42 | 25 237 | 25 279 | 1 952 | **27 231** |
| **Balance as at 31.12.2018** | **26 016** | **46 653** | **3 451** | **2 090** | **75 430** | **153 640** | **4 123** | **157 763** |

Additional information on equity is provided in Note 21.

Notes on pages 53 to 146 are an integral part of the consolidated financial statements.

# Notes to the consolidated financial statements

## NOTE 1 General information

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards as adopted by European Union for the year ended 31 December 2018 for AS LHV Group and its subsidiaries AS LHV Pank, AS LHV Finance (subsidiary of AS LHV Pank), AS LHV Varahaldus and OÜ Cuber Technology (hereinafter referred together as "the Group" or "LHV"). AS LHV Group holds 65% interest in LHV Finance through AS LHV Pank. AS LHV Group held 50% + 1 share interest in UAB Mokilizingas till end of April 2018 (the financial results of the first 4 months are shown as discontinued operations in the current report).

AS LHV Group is a limited liability company incorporated in and domiciled in Estonia. The address of its registered office is Tartu mnt 2, Tallinn. AS LHV Group is a holding company, whose subsidiary AS LHV Pank provides banking, financial advisory and securities brokerage services to customers in Estonia and in UK. There are offices for client servicing in Tallinn and Tartu and also London branch was opened in 2018. AS LHV Finance offers hire-purchase services to merchants and consumer finance. AS LHV Varahaldus offers fund management services for pension funds and other funds to clients in Estonia. As at 31.12.2018 the Group employed 395 full-time employees, incl. 23 non-active (31.12.2017: 365 employees, incl. 16 non-active).

The consolidated annual report (incl. financial statements) was approved by the management board on 18h of February 2019. Rain Lõhmus, who owns 24.9% of the voting rights and Andres Viisemann, who owns 9.8% of the voting rights (see also Note 21), have significant influence over AS LHV Group.

The consolidated annual report approved by the management board shall be authorised for approval by the supervisory board and shareholders. The shareholders have the right not to approve the consolidated annual report while the supervisory board does not have that right.

## NOTE 2 Summary of significant accounting policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all the years presented and to all the consolidated group entities, unless otherwise stated.

### 2.1 Basis of preparation

The consolidated financial statements of the Group for the financial year 2018 have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. The financial statements have been prepared under the historical cost convention, except as disclosed in some of the accounting policies below, such as: "financial assets and liabilities at fair value through profit or loss", including derivatives and assets held for trading.

The preparation of consolidated financial statements in accordance with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements, are disclosed in Note 4.

The financial year started at 1 January 2018 and ended at 31 December 2018. The financial figures have been presented in thousands of euros unless referred differently in specific disclosures.

Certain new IFRS amendments to existing standards and the interpretations of the standards have been published by the time of compiling these financial statements, which became mandatory for the Group's reporting periods beginning on or after 1 January 2018. The overview of these standards and the potential impact of applying the new standards and interpretations are stated below.

#### (a) Adoption of new or revised standards and interpretations

The following new or revised standards and interpretations became effective for the Group from 1 January 2018.

**IFRS 9, Financial instruments** (effective for annual periods beginning on 1 January 2018). LHV has not restated the comparative figures for 2017 in the 2018 annual report as simplified application of IFRS 9 was implemented by management. Key features of the new standard are as follows:

- Financial assets are required to be classified into three measurement categories
- assets to be measured subsequently at amortised cost (AC)
- assets to be measured subsequently at fair value through other comprehensive income (FVOCI)
- assets to be measured subsequently at fair value through profit or loss (FVPL).

The classification and measurement requirements in IFRS 9 state that financial assets should be classified as and measured at, amortized cost, fair value through profit and loss or fair value through other comprehensive income. The classification of a debt instruments is dependent on the business model for the portfolio where the instrument is included and on whether the asset cash flows are solely payments of principal and interest (SPPI). In order to assess the business model, LHV has divided its financial assets into portfolios and/or sub-portfolios based on how groups of financial assets are managed together to achieve a particular business objective. If a debt instrument is held to collect, it may be carried at amortised cost if it also meets the SPPI requirement. Debt instruments that meet the SPPI requirement that are held in a portfolio where an entity both holds to collect assets' cash flows and sells assets may be classified as FVOCI. Financial assets that do not contain cash flows that are SPPI must be measured at FVPL (for example, derivatives). Embedded derivatives are no longer separated from financial assets but will be included in assessing the SPPI condition.

Investments in equity instruments are always measured at fair value. However, management can make an irrevocable election to present changes in fair value in other comprehensive income, provided the instrument is not held for trading. If the equity instrument is held for trading, changes in fair value are presented in profit or loss.

Requirements in IAS 39 for classification and measurement of financial liabilities were carried forward unchanged to IFRS 9. The key change is that an entity will be required to present the effects of changes in own credit risk of financial liabilities designated at fair value through profit or loss in other comprehensive income.

There were no significant changes in the measurement of financial instruments compared to IAS 39. No significant impact was on LHV's financial position, financial performance or equity in the period of initial application from classification and measurement changes. See also transition table below.

The impairment requirements in IFRS 9 are based on an expected loss model as opposed to the current incurred loss model in IAS 39. The scope of IFRS 9 impairment requirements is also broader than IAS 39, IFRS 9 requires all assets measured at amortized cost and fair value through other comprehensive income, as well as off-balance commitments including guarantees and loan commitments, to be included in the impairment test. The assets to test for impairment will be divided into three groups depending on the stage of credit deterioration. Stage 1 includes assets where there has been no significant increase in credit risk, stage 2 includes assets where there has been a significant increase in credit risk and stage 3 includes defaulted assets. Significant assets in stage 3 are tested for impairment on an individual basis, while for insignificant assets a collective assessment is performed. In stage 1, the provisions should equal the 12 month expected loss. In stage 2 and 3, the provisions should equal the Lifetime expected losses.

One important driver for size of provisions under IFRS 9 is the trigger for transforming an asset from stage 1 to stage 2. The transition to IFRS 9 brought the change in loan provisions in the amount of EUR 749 thousand. For assets to be recognized going forward, changes to the lifetime Probability of Default (PD) will be used as the trigger. In addition customers with forbearance measures and customers with payments more than thirty days past due will also be transferred to stage 2.

The provisions under IFRS 9 will be calculated as the exposure at default times the probability of default times the loss given default. For assets in stage 1 this calculation will only be based on the coming 12 months, while it for assets in stage 2 will be based on the expected lifetime of the asset.

For assets where there has been a significant increase in credit risk, LHV currently holds provisions based on the losses estimated to occur during the period between the date when the loss event occurred and the date when the loss event is identified on an individual basis, while IFRS 9 will require provisions equal to the lifetime expected loss. When calculating lifetime losses under IFRS 9, including the staging assessment, the calculation should be based on probability weighted forward-looking information.

Impairment calculations under IFRS 9 will require more experienced credit judgement by the reporting entities than required by IAS 39 previously and a higher subjectivity is thus introduced. The inclusion of forward looking information adds complexity and makes provisions more dependent on management's view of the future economic outlook. It is expected that the impairment calculations under IFRS 9 will be more volatile and pro-cyclical than under IAS 39, mainly due to the significant subjectivity applied in the forward-looking scenarios.

The main change to the general hedge accounting requirements is that the standard aligns hedge accounting more closely with the risk management activities, these changes will not have direct effect on LHV, as LHV is currently not using hedge accounting. Same time we see that the regulation changes will generate some new possibilities to LHV to start using hedge accounting for reducing volatility in financial statements for positions which are hedged with ones treated differently in accounting.

The following table reconciles the carrying amounts of financial assets, from their previous measurement categories in accordance with IAS 39 into their new measurement categories upon transition to IFRS 9 on 1 January 2018:

| *(in thousands of euros)* | Note | Measurement category | | Carrying value per IAS 39 (closing balance at 31 December 2017) (a) | Impairment allowance per IAS39 (closing balance at 31 December 2017) (b) | Effect Remeasurement (c) | Carrying value per IFRS 9 (opening balance at 1 January 2018) (a+c) | Impairment allowance per IFRS 9 (opening balance at 1 January 2018) (b+c) |
|---|---|---|---|---|---|---|---|---|
| | | IAS 39 | IFRS 9 | | | ECL | | |
| Due from credit institutions | 10 | L&R | AC | 26 312 | 0 | 0 | 26 312 | 0 |
| Due from investment companies | 10 | L&R | AC | 14 186 | 0 | 0 | 14 186 | 0 |
| Due from central bank | 10 | L&R | AC | 920 714 | 0 | 0 | 920 714 | 0 |
| **Total cash and cash equivalents** | | | | **961 212** | **0** | **0** | **961 212** | **0** |
| Debt instruments | 11 | AFS | FVOCI (mandatory) | 555 | 0 | 0 | 555 | 0 |
| Debt instruments | 12 | FVTPL | FVTPL (mandatory) | 49 239 | 0 | 0 | 49 239 | 0 |
| **Total debt instruments** | | | | **49 794** | **0** | **0** | **49 794** | **0** |
| Equity instruments | 11 | AFS | FVOCI (voluntary) | 220 | 0 | 0 | 220 | 0 |
| Fund units | 12 | FVTPL | FVTPL (mandatory) | 6 620 | 0 | 0 | 6 620 | 0 |
| **Total equity instruments** | | | | **6 840** | **0** | **0** | **6 840** | **0** |
| Loans and advances to customers | 13 | L&R | AC | 732 043 | -8 125 | -693 | 731 387 | -8 818 |
| Receivables from customers | 14 | L&R | AC | 9 800 | 0 | 0 | 9 800 | 0 |
| Other financial assets | 15 | L&R | AC | 2 289 | 0 | 0 | 2 289 | 0 |
| **Total financial assets** | | | | **1 761 978** | **-8 125** | **-693** | **1 761 136** | **-8 818** |
| Loan commitments | 23 | | | 0 | 0 | -20 | 0 | -20 |
| Financial guarantees | 23 | | | 0 | 0 | -36 | 0 | -36 |

**Prepayment Features with Negative Compensation, Amendments to IFRS 9** (effective for annual periods beginning on 1 January 2018) The amendments enable measurement at amortised cost of certain loans and debt securities that can be prepaid at an amount below amortised cost, for example at fair value or at an amount that includes a reasonable compensation payable to the borrower equal to present value of an effect of increase in market interest rate over the remaining life of the instrument. In addition, the text added to the standard's basis for conclusion reconfirms existing guidance in IFRS 9 that modifications or exchanges of certain financial liabilities measured at amortised cost that do not result in the derecognition will result in an gain or loss in profit or loss. Reporting entities will thus in most cases not be able to revise effective interest rate for the remaining life of the loan in order to avoid an impact on profit or loss upon a loan modification. The Group applied the amendment to the standard together with IFRS 9. The guidance for changing the standard has been taken into account when assessing whether the cash flows from financial assets meet SPPI requirement.

**IFRS 15, Revenue from contracts with customers** (effective for annual periods beginning on 1 January 2018). The new standard introduces the core principle that revenue must be recognised when the goods or services are transferred to the customer, at the transaction price. Any bundled goods or services that are distinct must be separately recognised, and any discounts or rebates on the contract price must generally be allocated to the separate elements. When the consideration varies for any reason, minimum amounts must be recognised if they are not at significant risk of reversal. Costs incurred to secure contracts with customers have to be capitalised and amortised over the period when the benefits of the contract are consumed. It had the largest impact on AS LHV Varahaldus, where sales costs from previous years were capitalised and amortized over the expected lifetime of the customer contract, which in the case of pension funds is above 20 years. Previously, under IAS 18, the expenses were allowed to be capitalised only until the customer had first opportunity to change pension fund, ie the time period was shorter than 1 year. This effect significantly increased LHV Varahaldus' own funds at the moment of adoption of this IFRS standard. As at 1 January 2018, the Group's retained earnings through

LHV Varahaldus was increased by the sales costs incurred and capitalized until the end of 2017 in the amount of EUR 10 617 thousand and the assets was increased in the same amount. From 1 January 2018, the sales expenses have been be recognized as intangible assets and in the income statement, the sales expenses will be replaced with depreciation costs from client contracts. See more information in Note 9.

**Revenue from Contracts with Customers** - Amendments to IFRS 15 (effective for annual periods beginning on 1 January 2018).

The amendments do not change the underlying principles of the standard but clarify how those principles should be applied. The amendments clarify how to identify a performance obligation (the promise to transfer a good or a service to a customer) in a contract; how to determine whether a company is a principal (the provider of a good or service) or an agent (responsible for arranging for the good or service to be provided); and how to determine whether the revenue from granting a licence should be recognised at a point in time or over time. In addition to the clarifications, the amendments include two additional reliefs to reduce cost and complexity for a company when it first applies the new standard. The new standard did not have material impact on the Group's financial statements.

### (b) New accounting pronouncements

Certain new or revised standards and interpretations have been issued that are mandatory for the Group's annual periods beginning on or after 1 January 2019, and which the Group has not early adopted.

**IFRS 16, Leases** (effective for annual periods beginning on or after 1 January 2019). The new standard sets out the principles for the recognition, measurement, presentation and disclosure of leases. All leases result in the lessee obtaining the right to use an asset at the start of the lease and, if lease payments are made over time, also obtaining financing. Accordingly, IFRS 16 eliminates the classification of leases as either operating leases or finance leases as is required by IAS 17 and, instead, introduces a single lessee accounting model. Lessees will be required to recognise: (a) assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value; and (b) depreciation of lease assets separately from interest on lease liabilities in the income statement. IFRS 16 substantially carries forward the lessor accounting requirements in IAS 17. Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for those two types of leases differently. Starting from 1 January 2019, EUR 4 042 thousand will be recognized on the Group's statement of financial position as assets and liabilities, thus increasing the total of the statement of financial position of the Group.

**Annual Improvements to IFRSs 2015-2017 cycle** (effective for annual periods beginning on or after 1 January 2019; not yet adopted by the EU).

The narrow scope amendments impact four standards. IFRS 3 was clarified that an acquirer should remeasure its previously held interest in a joint operation when it obtains control of the business. Conversely, IFRS 11 now explicitly explains that the investor should not remeasure its previously held interest when it obtains joint control of a joint operation, similarly to the existing requirements when an associate becomes a joint venture and vice versa. The amended IAS 12 explains that an entity recognises all income tax consequences of dividends where it has recognised the transactions or events that generated the related distributable profits, eg in profit or loss or in other comprehensive income. It is now clear that this requirement applies in all circumstances as long as payments on financial instruments classified as equity are distributions of profits, and not only in cases when the tax consequences are a result of different tax rates for distributed and undistributed profits. The revised IAS 23 now includes explicit guidance that the borrowings obtained specifically for funding a specified asset are excluded from the pool of general borrowings costs eligible for capitalisation only until the specific asset is substantially complete. The Group is currently assessing the impact of the new amendments.

**Amendments to the Conceptual Framework for Financial Reporting** (effective for annual periods beginning on or after 1 January 2020; not yet adopted by the EU).

The revised Conceptual Framework includes a new chapter on measurement; guidance on reporting financial performance; improved definitions and guidance - in particular the definition of a liability; and clarifications in important areas, such as the roles of stewardship, prudence and measurement uncertainty in financial reporting. The Group is currently assessing the impact of the new amendment.

**Definition of a business – Amendments to IFRS 3** (effective for annual periods beginning on or after 1 January 2020; not yet adopted by the EU).

The amendments revise definition of a business. A business must have inputs and a substantive process that together significantly contribute to the ability to create outputs. The new guidance provides a framework to evaluate when an input and a substantive process are present, including for early stage companies that have not generated outputs. An organised workforce should be present as a condition for classification as a business if are no outputs. The definition of the term 'outputs' is narrowed to focus on goods and services provided to customers, generating investment income and other income, and it excludes returns in the form of lower costs and other economic benefits. It is also no longer necessary to assess whether market participants are capable of replacing missing elements or integrating the acquired activities and assets. An entity can apply a 'concentration test'. The assets acquired would not represent a business if substantially all of the fair value of gross assets acquired is concentrated in a single asset (or a group of similar assets). The Group is currently assessing the impact of the new amendment.

**Definition of materiality – Amendments to IAS 1 and IAS 8** (effective for annual periods beginning on or after 1 January 2020; not yet adopted by the EU).

The amendments clarify the definition of material and how it should be applied by including in the definition guidance that until now has featured elsewhere in IFRS. In addition, the explanations accompanying the definition have been improved. Finally, the amendments ensure that the definition of material is consistent across all IFRS Standards. Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity. The Group is currently assessing the impact of the new amendment.

There are no other new or revised standards or interpretations that are not yet effective that would be expected to have a material impact on the Group.

## 2.2 Consolidation

The 2018 consolidated financial statements include the financial statements of AS LHV Group (parent company) and its subsidiaries AS LHV Pank, AS LHV Finance (subsidiary of AS LHV Pank), AS LHV Varahaldus and OÜ Cuber Technology. AS LHV Group holds 65% interest in LHV Finance through AS LHV Pank. Until May 2018 AS LHV Group held 50% + 1 share interest in UAB Mokilizingas.

Subsidiaries are all entities over which the Group has control. The Group controls an entity when the Group is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. The acquisition method of accounting is used to account for the acquisition of subsidiaries (except for acquisitions among enterprises under common control) and business operations. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange. Transaction costs incurred for issuing equity instruments are deducted from equity; transaction costs incurred for issuing debt are deducted from its carrying amount and all other transaction costs associated with the acquisition are expensed. According to the acquisition method, the identifiable assets, liabilities and contingent liabilities of the acquired subsidiary are recognized at their fair values at the acquisition date, irrespective of the extent of any non-controlling interest.

The Group measures non-controlling interest that represents present ownership interest and entitles the holder to a proportionate share of net assets in the event of liquidation on a transaction by transaction basis, either at: (a) fair value, or (b) the non-controlling interest's proportionate share of net assets of the acquiree. Non-controlling interests that are not present ownership interests are measured at fair value.

Goodwill is measured by deducting the net assets of the acquiree from the aggregate of the consideration transferred for the acquiree, the amount of non-controlling interest in the acquiree and fair value of an interest in the acquiree held immediately before the acquisition date. Any negative amount ("negative goodwill") is recognised in profit or loss, after management reassesses whether it identified all the assets acquired and all liabilities and contingent liabilities assumed, and reviews appropriateness of their measurement.

Intercompany transactions balances and unrealised gains on transactions between group companies are eliminated; unrealised losses are also eliminated unless transaction provides evidence of an impairment of the asset transferred.

Revenues and expenses of the subsidiaries acquired within the financial year are consolidated into the Group's statement of profit or loss and other comprehensive income starting from the date of acquisition to the end of the financial year. Result of operations of subsidiaries disposed of during the year are consolidated into Group's statement of profit or loss and other comprehensive income from the beginning of the financial year until the date of disposal.

Pursuant to the Accounting Act of the Republic of Estonia, information of the unconsolidated financial statements (primary statements) of the consolidating entity (parent company) shall be disclosed in the notes to the consolidated financial statements. In preparing the primary financial statements of the parent company, the same accounting policies have been used as in preparing the consolidated financial statements. The accounting policy for accounting subsidiaries has been amended in the separate primary financial statements disclosed as supplementary information in the Annual Report in conjunction with IAS 27 “Separate Financial Statements”.

In the parent separate primary financial statements, disclosed in these consolidated financial statements (see Note 27), the investments into the shares of subsidiaries are accounted for at cost less any impairment recognized.

Non-controlling interest is that part of the net results and of the net assets of a subsidiary, which is attributable to interests, which are not owned, directly or indirectly, by the Group. Non-controlling interest forms a separate component of the Group’s equity. Non-controlling interest in the consolidated statement of financial position is disclosed separately from the equity attributable to the shareholders of the parent company. In consolidated statement of profit or loss and other comprehensive income, non-controlling interest share of profit is disclosed separately from owners of the parent.

## 2.3 Associates

An associate is an entity over which the Group has significant influence but which it does not control. Generally, significant influence is assumed to exist when the Group holds between 20% and 50% of the voting rights. The Group does not have any associate as at 31.12.2018 and 31.12.2017

In the consolidated financial statements, investments in associates are accounted for using the equity method. Under this method, the investment is initially recognized at cost which is thereafter adjusted for post-acquisition changes in the investor’s share of the investee’s equity (changes both in the profit/loss of the associate as well as other equity items) and with elimination or depreciation/amortisation of the differences between fair values and carrying amounts of the investee’s assets, liabilities and contingent liabilities as determined in the purchase analysis. Unrealized gains on transactions between the Group and its associates are eliminated to the extent of the Group’s interest in the associates. Unrealized losses are also eliminated unless the transaction provides evidence of impairment of the assets.

When the Group’s share of losses in the associate accounted under the equity method exceeds the carrying amount of the associate, the carrying amount of the investment is reduced to zero and such long-term loans granted to the associate that in substance form a part of the investment are written down. Further losses are carried off-balance sheet. When the Group has guaranteed or incurred obligations on behalf of the associate, the respective liability as well as the loss under the equity method are recorded in the statement of financial position. Other receivables from the associate are recorded at amortised cost less a provision for impairment.

An investment in the assets and liabilities of the acquired associate and goodwill that arose on acquisition is presented as a net amount in the statement of financial position line “Investments in associates”.

At the end of each reporting period, it is assessed whether there is any indication that the recoverable amount of the investment has fallen below its carrying amount. If any such indications exist, an impairment test is performed. To determine the recoverable amount of the investment, the principles described in section 2.10 are used.

## 2.4 Foreign currency translation

### (a) Functional and presentation currency

The functional and presentation currency of entities in the Group is euro.

### (b) Foreign currency transactions and balances

Foreign currency transactions are recorded based on the foreign currency exchange rates of the European Central Bank prevailing at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated into euros based on the foreign currency exchange rates of the European Central Bank prevailing at the end of the reporting period. Non-monetary financial assets and liabilities measured at fair value denominated in foreign currencies are translated into euros based on the foreign currency exchange rates of the European Central Bank prevailing at the fair value measurement date. Gains and losses on translation from monetary assets and liabilities are recorded in the statement of profit or loss under the line “Foreign exchange rate gains/losses". Translation differences on non-monetary items, such as equities held at fair value through profit or loss, are reported as part of the fair value gain or loss in the statement of profit or loss under the line “Foreign exchange rate gains/losses".

## 2.5 Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise cash on hand, demand deposits with central bank and other banks and investment companies, term deposits with original maturities of three months or less, that are available for use without any restrictions and which are subject to an insignificant risk of changes in value.

## 2.6 Financial assets

*Accounting policies from 1 January 2018*

**Initial recognition and derecognition**

Financial assets are recognised on the statement of financial position when the Group becomes a party to the contractual provisions of the instrument and are measured at fair value on initial recognition. Transaction costs are included in the fair value on initial recognition except for financial assets at fair value through profit or loss where transaction costs are expensed in profit or loss. Financial assets at fair value are recognised on the statement of financial position on trade date. Financial assets measured at amortised cost are recognised on trade date.

Financial assets are derecognised when (a) the assets are redeemed or the rights to cash flows from the assets otherwise expired or (b) the Group has transferred the rights to the cash flows from the financial assets or entered into a qualifying pass-through arrangement while (i) also transferring substantially all risks and rewards of ownership of the assets or (ii) neither transferring nor retaining substantially all risks and rewards of ownership, but not retaining control.

Control is retained if the counterparty does not have the practical ability to sell the asset in its entirety to an unrelated third party without needing to impose restrictions on the sale.

**Subsequent measurement**

The Group classifies and subsequently measures its financial assets in the following categories: financial instruments at fair value through profit or loss; fair value through other comprehensive income and amortised cost. The classification will depend on if the financial asset is a debt instrument, an equity instrument or a derivative.

Debt instruments (Loans and debt securities)

The classification is based on a combination of assessing the business model for managing the financial assets and whether the contractual cash flows consist of solely payments of principal and interest ('SPPI'). The business model assessment is performed for homogenous portfolios/products identified based on how the business is managed in the divisions of the Group. The assessment is based on reasonable scenarios taking into consideration how the portfolio is evaluated and reported to management; the risks affecting the performance of the portfolio and how these risks are managed; how managers are compensated; and the frequency, value and timing of sales including the reasons for the sales. In determining if the cash flows consist solely of principal and interest, the principal is defined as the fair value of the debt instrument at initial recognition, which can change over the life if there are repayments or capitalisation of interest. Interest cash flows are consistent with components per a basic lending arrangement including consideration for time value of money, credit risk, liquidity risk as well as administrative costs and profit margin. If there are contractual features introducing an exposure to other risks or volatility, it is not considered to consist of solely payments of principal and interest. SPPI tests are performed as a part of new product approval tests. In implementation of IFRS 9 SPPI was applied to 22 larger products carried at amortised cost. All products except one remained in accounting with same treatment. With remaining one – margin loan, the product conditions were changed before 1 January 2018 so that one functionality was taken out of the product and then product also passed SPPI. Therefore, all the LHV products remained with same accounting treatment as before.

Debt instruments are presented in the statement of financial position line items: Due from central banks, credit institutions and investment companies; Loans and advances to customers; Financial assets at fair value through other comprehensive income; Financial assets at fair value through profit or loss; Receivables from customers and Other financial assets, and include instruments in the following measurement categories.

Fair value through profit or loss: Debt instruments are classified in this category if not meeting the criteria for amortised cost or fair value through other comprehensive income. This is the case if the business model is held for trading; where financial assets are considered held for trading if they are held with the intention to be sold in the short-term and for the purpose of generating profits. Debt instruments are mandatorily measured at fair value through profit or loss if the assets are managed and evaluated on a fair value basis or the assets are held with an intention to sell, or alternatively, if the cash flows do not consist of solely payments of principal and interest.

Fair value through other comprehensive income: Debt instruments are classified in this category if both of the following criteria are met (a) the business model objective is to both hold assets to collect contractual cash flows and to sell the assets (b) the contractual cash flows consist of solely payments of principal and interest. The assets are measured at fair value and gains and losses arising from changes in fair value are reported in other comprehensive income and accumulated in equity. The cumulative gain or loss is reclassified from equity to profit or loss upon derecognition of the debt instrument. Interest is calculated by applying the effective interest method on interest-bearing financial assets and expected credit losses are recognised in profit or loss.

Amortised cost: Debt instruments are classified in this category if both of the following criteria are met (a) the business model objective is to hold assets to collect contractual cash flows and (b) the contractual cash flow characteristics consist of solely payments of principal and interest. The gross carrying amount of these assets is measured using the effective interest method and adjusted for expected credit losses.

Equity instruments

Equity instruments are per default classified as financial assets at fair value through profit or loss. An irrevocable election can be made on initial recognition to classify equity instruments (not held for trading) at fair value through other comprehensive income.

Derivatives

Derivatives are classified as fair value through profit or loss (held for trading).

**Modification**

The Group may renegotiate loans and modify contractual terms. If the new terms are substantially different from the original terms, the Group derecognises the original financial asset and recognises a new asset. The Group also assesses whether the new financial asset is credit-impaired at initial recognition. If the terms are not substantially different, the modification does not result in derecognition and the Group recalculates the gross carrying amount based on the new cash flows using the original effective interest rate of the financial asset and recognises a modification gain or loss.

**Reclassification**

In rare circumstances debt instruments (financial assets) excluding those designated at fair value through profit or loss on initial recognition, can be reclassified if there has been a change in the business model for managing the financial asset.

**Write-off**

The Group writes off financial assets, in whole or in part, when it has exhausted all practical recovery efforts and has concluded that there is no reasonable expectation of recovery. The write-off represents a dercognition event.

Indicators that there is no reasonable expectation of recovery include (i) ceasing enforcement activity and (ii) where the Group's recovery method is foreclosing on collateral and the value of the collateral is such that there is no reasonable expectation of recovery.

If it is not feasible or economically reasonable for the Group to take measures to recover the claims that are being discounted, the claim is assessed as non-performing and is removed from the statement of financial position. If an irrecoverable claim is received subsequently, receipts are recognized as income.

At least one of the conditions has to be filled to declare claim irredeemable based on the product class.

| IFRS 9 category | | Class (applied by the Group) | | 31.12.2018 |
|---|---|---|---|---|
| Financial assets | Amortised cost | Loans and advances to banks and investment companies | | 682 658 |
| | | Loans and advances to customers | Loans to legal entities | 705 186 |
| | | | Loans to individuals | 213 575 |
| | | Other receivables | | 3 721 |
| | | Other financial assets | | 2 936 |
| | Financial assets at fair value through profit and loss | Mandatory measurement at fair value through profit or loss | Shares and fund units | 510 |
| | | | Listed bonds | 38 697 |
| | | | Derivatives | 59 |
| | | | Pension fund units | 7 590 |
| | Equity instruments at fair value through other comprehensive income | Investment securities | Unlisted shares | 298 |

*Accounting policies until 31 December 2017*

The Group classifies its financial assets into the following categories:

- financial assets at fair value through profit or loss
- held-to-maturity financial investments
- available-for-sale financial assets
- loans and receivables

The classification depends on the purpose for which the financial assets were acquired. Management of the Group determines the classification of its financial assets at initial recognition.

| IAS 39 category | | Class (applied by the Group) | | 31.12.2017 |
|---|---|---|---|---|
| Financial assets | Loans and receivables | Loans and advances to banks and investment companies | | 961 212 |
| | | Loans and advances to customers | Loans to legal entities | 542 913 |
| | | | Loans to individuals | 189 130 |
| | | Other receivables | | 9 800 |
| | | Other financial assets | | 2 289 |
| | Financial assets at fair value through profit and loss | Securities held for trading | Shares and fund units | 430 |
| | | | Listed bonds | 49 138 |
| | | | Derivatives | 30 |
| | | Designated as at fair value through profit or loss upon initial recognition | Pension fund units | 6 261 |
| | Available-for-sale financial assets | Investment securities | Listed bonds | 555 |
| | | | Unlisted shares | 220 |

**(a) Financial assets at fair value through profit or loss**

Financial assets at fair value through profit or loss include

- financial assets held for trading (incl. derivatives)
- financial assets classified at fair value through profit or loss at inception

A financial asset is classified as **held for trading** if acquired or incurred principally for the purpose of selling or repurchasing it in the near term. Derivatives are classified as held for trading unless they are designated as hedges.

Regular way purchases and sales of financial investments are recognised at the trade date in the statement of financial position.

Financial instruments included in this category are initially recognised at fair value; transaction costs are taken directly to the profit or loss. After initial recognition, financial assets in this category are measured at fair value. Interest income is calculated based on financial assets' amortised cost using the effective interest rate method and is recorded within interest income in the statement of profit or loss. Changes in fair values of these financial assets are recognised consistently, either as a profit or loss in the statement of profit or loss of the reporting period under "Net gains/losses from financial assets measured at fair value". In accounting for financial assets at fair value through profit or loss, the change in the value of assets between the trade date and the settlement date are taken to profit or loss, similarly to the recognition of similar assets in the ownership of the Group. Dividend income on financial assets measured at fair value through profit or loss are recognised in the line "Dividend income" of the statement of profit or loss when the right to receive dividends by the Group is established.

In case of listed securities (i.e. the securities which have an active market), the current bid price is considered as the fair value of investments. To estimate the fair value of investments not actively traded in the market, alternative methods such as the price of recent transactions (under market conditions), the discounted cash flow method or option valuation models are used.

Derivative financial instruments (futures, forward, swap and option contracts) are initially recognised in the statement of financial position at fair value at the trade date and are subsequently valued at fair value through profit or loss. If derivatives are quoted on an active market, market value is used as the fair value. Otherwise, the valuation techniques are used to estimate the fair value. Gains and losses from derivatives are recognised as income or expense of the period in the statement of profit or loss under "Net gains/losses from financial assets measured at fair value". Derivatives are carried in statement of financial position as assets, if their fair value is positive and as liabilities, if their fair value is negative. The fair values of derivative assets and liabilities recorded in the statement of financial position are not netted. The Group does not use hedge accounting to account for its derivative financial instruments.

Financial assets designated at fair value through profit or loss at inception - securities are classified into this group, if the Group has upon initial recognition designated the securities to be recorded as at fair value through profit or loss and as a result the changes in the fair value of these securities are consistently recognised in the profit or loss of the reporting period in the statement of profit or loss.

Financial assets and financial liabilities are designated at fair value through profit or loss when certain investments, such as debt or equity investments, are managed and evaluated on a fair value basis in accordance with a documented risk management or investment strategy and reported to key management personnel on that basis.

Refer to Note 3.5 for fair value of financial assets.

### (b) Held-to-maturity financial investments

Held-to-maturity financial investments are financial instruments quoted in an active market with a fixed due date and which the management board of the Group has an intention and opportunity to hold until their maturity. They do not include:

- investments designated as fair value through profit or loss upon their initial recognition;
- investments classified as available-for-sale assets;
- investments, which meet the criteria of loans and receivables.

These investments are initially recognised at fair value, plus all directly attributable transaction costs incremental to their acquisitions and they are subsequently measured at amortised cost using the effective interest rate method. Interest income on held-to-maturity investments is included within interest income in the statement of profit or loss. Impairment losses are deducted from the carrying amount of the investments and the impairment charge is recorded in the statement of profit or loss.

### (c) Available-for-sale financial assets

Available-for-sale financial assets are financial instruments which the Group intends to hold for an indefinite period of time and which may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Investment securities available-for-sale are carried at fair value. Interest income on available-for-sale debt securities is calculated using the effective interest method and recognised in profit or loss. Other changes in fair values of these financial assets are recognised in other comprehensive income.

### (d) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans and receivables to customers are recorded when the Group advances money to purchase or originate an unquoted non-derivative receivable from a customer due on fixed or determinable dates, and has no intention of trading the receivable. Loans and receivables are initially recognised at fair value plus transaction costs, and are derecognised only when they are repaid or written-off. After initial recognition, the Group recognises loans and receivables at amortised cost (less principal repayments and any potential impairment losses, if necessary) and calculates interest income on the receivable in subsequent periods using the effective interest method. In case of credit cards, the borrower's actual use of limit is recorded in the statement of financial position.

Finance lease transactions are lease transactions under which all significant risks and rewards from using the assets are immediately transferred from the Group to the lessee. Legal ownership of assets is transferred to the customer at the end of the lease term. Finance leases are capitalised at the inception of the lease at the lower of the fair value of the leased property and the present value of minimum lease payments (plus any unguaranteed residual value of the leased asset). Each lease payment received from the lessee is allocated between the receivable and finance income. Lease income is recognised over the term of the lease using the net investment method, which reflects a constant periodic rate of return. When there are service fees and initial direct costs attributable to the conclusion of lease agreements, they are included in the calculation of the effective interest rate of the lease and calculation of a finance lease receivable. The basis for assessing receivables is the timely fulfilment of contractual obligations, the estimated market price of the leased asset and excess collateral, the financial position and reliability of the customer. Impairment of receivables reduces the respective asset category in the statement of financial position.

Loans restructured because of significant changes in contract terms are recognised as new loans when a new loan has been issued, incl. refinancing an existing loan or increasing an existing loan for payment of the loan principal, interest, overdue penalties or other fees related to it. Loans which include a change in other contractual terms as a result of deterioration of the customer's credit quality do not qualify for derecognition.

Trade receivables arise from provision of services to the customers and are initially recognised at fair value plus transaction costs and subsequently measured at amortised cost using the effective interest method (less repayments and a provision for incurred impairment losses).

The impairment of loans and advances is assessed in accordance with the principles described in clause 2.7.

## 2.7 Impairment of financial assets carried at amortised cost

Accounting policy from 1 January 2018

**Measurement**

The impairment requirements are based on an expected credit loss (ECL) model. The guiding principle of the ECL model is to reflect the general pattern of deterioration or improvement in the credit quality of financial instruments.

All financial assets measured at amortised cost and fair value through other comprehensive income, as well as lease receivables, financial guarantees contracts, contract assets and certain loan commitments are in scope for expected credit loss.

ECLs on financial assets measured at amortised cost and lease receivables are presented as allowances, i.e., as an integral part of the measurement of those assets in the statement of financial position. The allowance reduces the gross carrying amount. ECLs on loan commitments and financial guarantee contracts are presented as provisions, i.e., as a liability, in the statement of financial position. Adjustment to the loss allowance and provision due to changes in ECLs is recognised in the statement of profit or loss as net expected credit losses.

The assessment of credit risk, and the estimation of ECL, shall be unbiased and probability-weighted, and shall incorporate all available information which is relevant to the assessment, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. LHV uses both models and expert based individual assesments for calculating ECLs.

The ECL model has a three-stage approach based on changes in the credit risk. A 12-month ECL (Stage 1) applies to all items, unless there is a significant increase in credit risk since initial recognition. For items where there is a significant increase in credit risk (Stage 2) or in default (Stage 3), lifetime ECL applies.

**Significant increase in credit risk**

At the end of each reporting period the Group performs an assessment of whether credit risk has increased significantly since initial recognition. The assessment of whether there has been a significant change in credit risk is based on quantitative and qualitative indicators. Indicators include payments that are past due >30 days and <90 days and financial assets that have been classified as watch-list or with forbearance measures (loans whose contractual terms have been revised due to the customer's financial difficulties). A quantitative indicator is calculated based on the change in lifetime probability of default (PD) by comparing the scenario-weighted lifetime PD at the reporting date with the scenario-weighted lifetime PD at initial recognition. In case there has been a significant increase in credit risk since initial recognition, an allowance for lifetime ECL shall be recognised and the financial instrument is transferred to Stage 2. The approach is symmetrical, meaning that in subsequent reporting periods, if the credit quality of the financial instrument improves such that there is no longer a significant increase in credit risk since initial recognition, the financial asset moves back to Stage 1.

**Definition of default**

The Group defines a financial instrument as in default, which is fully aligned with the definition of credit-impaired, when it meets one or more of the following criteria:

**Quantitative criteria**

The borrower is more than 90 days and over 10 euros past due on its contractual payments. The threshold of 10 euros is put in place with debt management procedures that is a trigger for debt collection activities and also indicated as materiality threshold in Definition of Default.

**Qualitative criteria**

The borrower meets unlikeliness to pay criteria, which indicates the borrower is in significant financial difficulty. The following circumstances are considered as indicators for the customer not to pay the debt in full:

- Non-accrued status is applied to the contract
- Specific credit adjustments has been formed due to the decline in the credit quality
- Sale of credit obligation with economic loss higher than 5 %
- Distressed restructuring measures have been applied to the contract resulting with diminished financial obligation higher than 1 %
- It is becoming probable that the borrower will enter bankruptcy or has filed for bankruptcy
- a customer's resources of cash flow are no longer available to meet the payments of instalments
- The Group has called any collateral including a guarantee.

The criteria above have been applied to all financial instruments held by the Group and are consistent with the definition of default used for internal credit risk management purposes. Financial instruments in default are in Stage 3. All financial assets in Stage 3 are considered credit-impaired.

**Modelling**

The ECL is calculated as a function of the probability of default (PD), the exposure at default (EAD) and the loss given default (LGD), as well as the timing of the loss. The Group's IFRS 9 methodology for ECL measurement is based on existing internal scoring and rating models.

PD represents the likelihood that a loan will not be repaid and will go into default in either a 12-month or lifetime horizon. The expected PD for each individual instrument incorporates a consideration of past events, current market conditions and reasonable and supportable information about future economic conditions. LHV uses existing scoring and rating models that are adjusted according to specific IFRS 9 requirements. The models are calibrated based on a combination of asset class and product type.

EAD represents an estimate of the outstanding amount of credit exposure at the time a default may occur. For off-balance sheet amounts, EAD includes an estimate of any further amounts to be drawn at the time of default. LGD is the amount that may not be recovered in the event of default. LGD takes into consideration the amount and quality of any collateral held. LHV uses existing LGD models adjusted to meet IFRS 9 requirements. When measuring ECL, LHV uses the maximum contractual period during which LHV is exposed to risk.

**Forward-looking information**

The Group uses internally developed macroeconomic forecasts as the basis for the forward-looking information incorporated in the ECL measurement. In order to ensure an unbiased estimation of credit losses under IFRS 9, at least three scenarios shall be used. One of the scenarios shall be the base case scenario, representing the most likely outcome, which is also applied in the regular financial planning and budgeting process, while other case scenarios shall represent more optimistic or pessimistic outcomes.

Forecasts are developed internally in the Credit Management Department that consults with the experts from Risk Control Unit, business and finance. As available without undue cost, external experts and externally developed 'benchmark forecasts' should be consulted. The referred benchmark forecasts include but are not limited to World Economic Outlook by the IMF, European Economic Forecasts by the European Commission and Economic Forecasts by Bank of Estonia. The scenarios shall be approved by the Risk and Capital Committee.

Scenarios are be developed for a time horizon over which reliable projections can be made, typically for a time horizon of 3 years. At minimum, selected macro indicators have to be forecasted for a period of two years following the current year. In general, scenarios are reviewed on a quarterly basis. In case of significant changes in the macroeconomic environment and outlook, the scenarios shall be updated.

**Individual assesments and Management´s judgement**

The Group uses both models and expert based judgement in order to determine ECLs. The degree of judgement that is required to estimate ECL depends on the model outcome, materiality and the availability of detailed information. The model provides guidance and transparency as to how economic events could affect the impairment of financial assets. Expert based judgement may be applied to the modelled outcome to incorporate an estimated impact of factors not captured by the model. Such individual ECL assesments may be applied to significant exposures at a counterparty level. These assesments are decided by the Credit Committee. In addition there may be a need for adjustments at a portfolio level, which is decided by the Risk and Capital Committee.

**Accounting policy until 31 December 2017**

Impairment losses are recognised in profit or loss for the year when incurred as a result of one or more events ("loss events") that occurred after the initial recognition of the financial asset and which have an impact on the amount or timing of the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. If the Group determines that, no objective evidence exists that impairment was incurred 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 impairment.

The Group assesses the risks taking into consideration all known information about the solvency of the customer and whether there are any objective circumstances indicating impairment (the customer's financial difficulties, bankruptcy or inability to meet its obligations to the Group).

Corporate loans, overdrafts and leases are assessed individually, primarily based on the overdue status of loan and realisable of related collateral, if any. Other criteria used to determine whether there is objective evidence that an impairment loss has occurred are financial position of the company, industry situation, reliability of the borrower, the competence of its management and other factors. Margin and repo loans secured by debt or equity securities both to legal as well as private individuals are assessed individually, using primarily the market value of collateral as the basis. Consumer loans, mortgage loans, credit card loans and hire-purchase loans are assessed as a group. Private individuals are assessed in terms of their timely fulfilment of obligations, solvency, value of the collateral, age, education, length of employment, savings habits and other factors impacting credit risk.

For the purposes of a collective evaluation of impairment, financial assets are grouped based on similar credit risk characteristics. 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 and the experience of management in respect of the extent to which amounts will become overdue as a result of past loss events and the success of recovery of overdue amounts. Past experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect past periods, and to remove the effects of past conditions that do not exist currently. The Group regularly reviews future cash flow assessment methods and assumptions, in order to reduce potential differences between loss estimates and actual losses.

If the terms of an impaired financial asset held at amortised cost are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. The renegotiated asset is then derecognized and a new asset is recognized at its fair value only if the risks and rewards of the asset substantially changed. This is normally evidenced by a substantial difference between the present values of the original cash flows and the new expected cash flows.

Impairment losses are always recognised through an allowance account to write down the asset's carrying amount to the present value of expected cash flows (which exclude future credit losses that have not been incurred) discounted at the original effective interest rate of the asset. The calculation of the present value of the estimated future cash flows of a collateralised 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. Any impairment losses are charged to statement of profit or loss line "Impairment losses on loans and advances".

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 recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss is reversed by adjusting the allowance account through profit or loss for the year. The reversal of the impairment loss is recognised as income in the line "Impairment losses on loans and advances" in the statement of profit or loss.

Uncollectible assets are written off against the related impairment loss provision after all the necessary procedures to recover the asset have been completed and the amount of the loss has been determined. Subsequent receipts of amounts previously written off are recognized in the income statement as a deduction from impairment charges.

Interest income on loans is presented on the statement of profit or loss under "Interest income".

## 2.8 Tangible fixed assets

Tangible fixed assets are non-current assets used in the operating activities of the Group with a useful life of over one year. An item of tangible fixed assets is initially recognised at its cost which consists of the purchase price (incl. customs duties and other non-refundable taxes) and other expenditures directly related to the acquisition that are necessary for bringing the asset to its operating condition and location. Subsequent costs are included in the asset's carrying amount or are recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. All other repairs and maintenance are charged to operating expenses during the reporting period in which they are incurred.

An item of tangible fixed assets is carried in the statement of financial position at cost less any accumulated depreciation and any accumulated impairment losses. Depreciation is calculated on a straight-line basis. The annual depreciation rate for computers, furniture and fixtures is 33%, for improvements of rental space either 20% p.a. or amortization throughout the rental period, depending on which is shorter. Depreciation is calculated starting from the month of acquisition until the carrying amount reaches the residual value of the asset. In case the residual value is greater than the carrying amount of the asset, no further depreciation expense is calculated.

The appropriateness of the assets´ residual values, depreciation methods used and useful lives are reviewed, and adjusted if appropriate, at the end of each reporting period. The Group performs an impairment test when there are circumstances indicating impairment. Where an asset's carrying amount is greater than its estimated recoverable amount (higher of an asset's fair value less costs to sell or its value in use), it is written down immediately to its recoverable amount recognising an impairment loss in the statement of profit or loss for the reporting period.

Gains and losses on disposals are determined by comparing proceeds with carrying amount. These are included in operating expenses or other income in the statement of profit or loss for the reporting period.

## 2.9 Intangible assets

Intangible assets are identifiable, non-monetary assets without physical substance and currently comprise of acquired software licences. An intangible asset is initially measured at cost, comprising of its purchase price and any directly attributable expenditure on preparing the asset for its intended use. After initial recognition, an intangible asset is carried at its cost less any accumulated amortisation and any accumulated impairment losses. Amortisation is calculated on a straight-line basis, except client agreements (see below). The annual amortisation rate for purchased licenses is 33%.

From 1 January 2018 due to the initial application of IFRS 15, sales costs for the acquisition of new clients is capitalised. Based on the simplified application method of the new standard chosen by management, comparative figures are not amended and full impact of previous periods is recognised on 1 January 2018 as increase in assets and retained earnings in amount 10 618 thousand euros. In addition, there are client agreements from business combination recorded as intangible assets, see Note 16. The amortisation method for client agreements is the diminishing balance method. The annual amortisation rate for purchased client agreements is 12% of the residual value of those assets. At the end of each reporting period, the appropriateness of amortization rates, methods and residual values is assessed. The Group reviews intangible assets for impairment losses whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the carrying amount of the asset exceeds its recoverable amount, which is the higher of an asset's fair value less costs to sell and value in use.

## 2.10 Impairment of assets

Assets that have indefinite useful lives (including goodwill) are not subject to amortization but they are tested annually for impairment, by comparing their carrying amounts with their recoverable amounts.

Assets with an unlimited useful life and depreciable assets are reviewed for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. In the event of such circumstances, the recoverable amount of the asset is assessed and is compared with the carrying amount.

An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount of the asset is the higher of an asset's fair value less costs to sell and value in use. For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating unit).

Impairment losses are recognized in statement of profit or loss.

At the end of each following reporting period, assets that have been written down are assessed to determine whether their recoverable amount has increased (except for impairment losses of goodwill that are not reversed). If the impairment test indicates that the recoverable amount of an asset or asset group (cash-generating unit) has increased above its carrying amount, the previous impairment loss is reversed up to the carrying amount that would have been determined (net of amortization or depreciation) had no impairment loss been recognised for the asset in prior years. Reversals of impairment losses are recognized in the statement of profit or loss as a reduction of the impairment loss.

## 2.11 Loan commitments, Financial guarantees and performance guarantees

The Group issues commitments to provide loans. These commitments are irrevocable or revocable only in response to a material adverse change. Such commitments are initially recognised at their fair value, which is normally evidenced by the amount of fees received. This amount is amortised on a straight line basis over the life of the commitment, except for commitments to originate loans if it is probable that the Group will enter into a specific lending arrangement and does not expect to sell the resulting loan shortly after origination; such loan commitment fees are deferred and included in the carrying value of the loan on initial recognition. At the end of each reporting period, the commitments are measured at (i) the remaining unamortised balance of the amount at initial recognition, plus (ii) the amount of the loss allowance determined based on the expected credit loss model, unless the commitment is to provide a loan at a below market interest rate, in which case the measurement is at the higher of these two amounts. The carrying amount of the loan commitments represents a liability. For contracts that include both a loan and an undrawn commitment and where the Group cannot separately distinguish the ECL on the undrawn loan component from the loan component, the ECL on the undrawn commitment is recognised together with the loss allowance for the loan. To the extent that the combined ECLs exceed the gross carrying amount of the loan, they are recognised as a liability.

The Group issues financial guarantees. Financial guarantees represent irrevocable assurances to make payments in the event that a customer cannot meet its obligations to third parties, and carry the same credit risk as loans. Financial guarantees are initially recognised at their fair value, which is normally evidenced by the amount of fees received. This amount is amortised on a straight line basis over the life of the financial guarantee. At the end of each reporting period, the financial guarantees are measured at the higher of (i) the amount of the loss allowance for the guaranteed exposure determined based on the expected loss model and (ii) the remaining unamortised balance of the amount at initial recognition. In addition, an ECL loss allowance is recognised for fees receivable that are recognised in the statement of financial position as an asset.

Performance guarantees are contracts that provide compensation if another party fails to perform a contractual obligation. Such contracts do not transfer credit risk. Performance guarantees are initially recognised at their fair value, which is normally evidenced by the amount of fees received. This amount is amortised on a straight-line basis over the life of the contract. At the end of each reporting period, the performance guarantee contracts are measured at the higher of (i) the unamortised balance of the amount at initial recognition and (ii) the best estimate of expenditure required to settle the contract at the end of each reporting period, discounted to present value. Where the Group has the contractual right to revert to its customer for recovering amounts paid to settle the performance guarantee contracts, such amounts will be recognised as loans and receivables upon transfer of the loss compensation to the guarantee's beneficiary.

## 2.12 Financial liabilities

The Group classifies financial liabilities either:

a) financial liabilities measured at fair value through profit or loss

b) financial liabilities measured at amortised cost

c) financial guarantee contracts and loan commitments

Recognition of a financial liability (derivative) at fair value through profit or loss is disclosed under accounting policy 2.6.a. All other financial liabilities are subsequently measured at amortised cost using the effective interest method. Transaction costs are included in the calculation of the effective interest rate. The difference between the proceeds (less transaction costs) and redemption value are recognised in the statement of profit or loss during the term of the instrument, using the effective interest rate. Interest costs are included in the statement of profit or loss line "Interest expenses".

Deposits from customers are initially recorded on their settlement date at their fair value less transaction costs and are subsequently measured at amortised cost using effective interest method in the statement of financial position line "Deposits from customers and loans received", accrued interest liabilities are included in the same line. Interest expense is recognised in the statement of profit or loss line "Interest expense" on the accrual basis.

Loans received, debt securities issued and similar subordinated debts are initially recognised at fair value, less transaction costs (cash received less transaction costs). The subordinated debts are those liabilities, which in case of a liquidation of a credit institution or declaration of bankruptcy, are settled after the satisfaction of the justifiable claims of other creditors. Other financial liabilities (trade payables, accrued expenses and other borrowings) are initially recognised at fair value less transaction costs and are subsequently carried at amortised cost.

Financial liabilities are derecognised when they are extinguished (ie. when the obligation specified in the contract is discharged, cancelled or expired).

## 2.13 Payables to employees

Payables to employees include unpaid salary accruals and a vacation pay accrual calculated in accordance with employment contracts and the laws in force in employee residential country as at the end of the reporting period. The liability related to the payment of a vacation pay accrual together with social security and unemployment insurance payments is included within current liabilities in the statement of financial position and as staff costs in the statement of profit or loss.

Social security tax includes payments to the state pension fund. Group has neither existing legal nor constructive obligations to make pension or similar payments supplementary to social security tax.

## 2.14 Share-based payments

AS LHV Group operates a share-based compensation plan, under which the company receives services from group employees as consideration for equity instruments (options) of LHV Group. The fair value of the employee services received in exchange for the grant of the options is recognised during the shared-based compensation program as group's staff expense and as an increase in the equity (other reserves). The total amount to be expensed is determined by the fair value at the time of issuing the options. The fair value of the options granted:

- including any market performance conditions influencing the share price (e.g. LHV Group share price);
- excluding the impact of any service and non-market performance vesting conditions (for example, profitability, sales growth targets and remaining an employee of the entity over a specified time period).

At the end of each reporting period, the Group revises its estimates of the number of options that are expected to vest based on the vesting conditions (other than market conditions). It recognises the impact of the revision to original estimates, if any, in the statement of profit or loss, with a corresponding adjustment to equity.

When the options are exercised, LHV Group issues new shares.

The grant by LHV Group of options over its equity instruments to the employees of subsidiary undertakings in the group is treated as a capital contribution. The fair value of employee services received, measured by reference to the grant date fair value, is recognised over the vesting period as an increase to investment in subsidiary undertakings, with a corresponding credit to equity in the parent entity accounts. According to the contractual conditions of the share options there are no social security tax charges when exercising the options after the 3-year period.

## 2.15 Provisions and contingent liabilities

Liabilities arising from an obligating event before the end of the reporting period that have either a legal basis or that have arisen from the Group's current operating practice (legal or constructive obligation) that require probable outflow of resources, the realisation of which is probable (it is more likely than not that an outflow of resources will be required to settle the obligation) and the amount of which can reliably be estimated but for which the timing or amount are not definitely known are recognised as provisions in the statement of financial position. The provisions are recognised based on the management's estimates regarding the amount and timing of the expected outflows. A provision is recognised in the statement of financial position in the amount which according to the management is necessary as at the end of the reporting period for the meeting of the obligation arising from the provision or transfer to the third party. The provision expense and an expense from the change in the carrying amount of provisions are included within expenses in the reporting period. Provisions are not set up to cover future operating losses.

When it is probable that a provision will be realised later than 12 months after the end of the reporting period it is recorded at discounted value (present value of expected outflows), unless the discounting effect is immaterial.

Other contingent liabilities (guarantees, except financial guarantees, and other commitments) the realisation of which is less probable than non-realisation or related costs cannot be determined reliably, that in certain circumstances may become obligations, are disclosed in the notes to the financial statements as contingent liabilities. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable on a portfolio basis. If it becomes probable that an outflow of future economic benefits will be required for an item or portfolio of items previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

## 2.16 Distinction between short- and long-term assets and liabilities

Assets from which resources are expected to flow to the Group within 12 months are recognised as current assets. The portion of assets with expected inflows later than 12 months after the end of the reporting period is recognised as non-current assets (see Note 3.4).

Liabilities are classified as current when they are due within twelve months after the end of the reporting period or if the Group does not have an unconditional right to defer the payment for later than 12 months after the end of the reporting period. Loans received with due date within 12 months after the end of the reporting period which are refinanced as non-current after the end of the reporting period but before the financial statements are authorised for issue, are recognised as current. Loans received that the lender has the right to recall at the end of the reporting period due to breaches of contractual terms are also classified as current.

For all long-term assets and liabilities, the long-term portion is separately disclosed in respective disclosure to these financial statements (see Note 3.4).

## 2.17 Revenues and expenses

Accounting policy from 1 January 2018

The effective interest method is applied to recognise interest income and interest expenses in profit or loss for financial assets and financial liabilities measured at amortised cost or debt investments at fair value through other comprehensive income.

The effective interest method is a method of calculating the gross carrying amount of a financial asset or the amortised cost of a financial liability and of allocating interest income and interest expenses. The effective interest rate is the rate that discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial instrument. When calculating future payments, all payments included in the terms and conditions of the contracts, such as advance payments, are taken into consideration. The calculation of the effective interest rate includes fees that are an integral part of the effective interest rate. However, expected credit losses are not taken into account.

If a financial asset subsequently has become credit impaired the interest income is recognised applying the effective interest rate to the amortised cost, i.e. gross carrying amount adjusted for the loss allowance. In case a financial asset is credit-impaired at initial recognition, the expected credit losses are included in the estimated cash flows to calculate a credit adjusted effective interest rate which then is applied to recognise the interest income.

### Fee and commission income

The recognition of revenue from contracts with customers is reported as fee and commission income. This does not apply for revenue from leasing contracts or financial instruments and other contractual obligations within the scope of IFRS 9 Financial Instruments.

Fees that are included in the calculation of the effective interest rate of a financial instrument measured at amortised cost, such as loan origination fees, are allocated over the expected tenor of the instrument applying the effective interest method and presented in Net interest income.

Fee and commission income is recognised to depict the transfer of promised services to the customers in an amount that reflects the consideration to which LHV expects to be entitled in exchange for the service.

Fee and commission income is recognised over time on a straight line basis as the services are rendered, when the customer simultaneously receives and consumes the benefits provided by the Group's performance. Variable fees are recognised only to the extent that management determines that it is highly probable that a significant reversal will not occur.

Other fee and commission income is recognised at a point in time when the Group satisfies its performance obligation, usually upon execution of the underlying transaction. The amount of fee or commission received or receivable represents the transaction price for the services identified as distinct performance obligations.

The major types of fees are described below.

Fee and commission income for asset custody and asset management to customers is recognised as revenue over the period in which the services are provided. Performance based fees are recognised when it is highly probable that a significant reversal of recognised revenue will not occur, which is most often when the performance criteria are fulfilled.

Brokerage fees, commission and fees from negotiating a transaction for a third party, such as arrangement of acquisitions or purchase or sale of a business, are recognised on completion of the transaction.

Expenses that are directly related to the generation of fee and commission income are recognised as fee and commission expense.

**Net financial income**

Gains and losses arising from changes in fair value of financial assets and liabilities measured at fair value through profit or loss are reported under the item Net gains from financial assets. For financial liabilities designated at fair value through profit or loss the change in fair value relating to change in own credit risk is accounted for in other comprehensive income.

**Dividend income**

Dividends are recognised when the entity's legal right to receive payment is established.

*Accounting policy until 31 December 2017*

Revenues and expenses are recorded on an accrual basis. Revenue is recognised when it is probable that the economic benefits associated with the transaction will be received by the Group, the amount of the revenue can be measured reliably and services were rendered by the Group. Revenue earned in the ordinary course of business is recognised at fair value of the fee received or receivable. Expenses are recognised when the Group has obligation to pay for the expense and/or the Group has received goods or services, and the latter occurs at an earlier date.

Fee and commission income (incl. custody and portfolio management fees) are recognised on an accrual basis when the service has been provided and the Group has a right of claim to the receivable. Commissions and fees arising from provision of advisory services to third parties (purchase or sale of businesses, acquisitions, etc.) are generally recognised upon completion of the underlying transaction or when service is provided over a longer period of time, based on the stage of completion method. Portfolio management, other consultation fees and management fees related to investment funds are recognised according to the agreement, usually over the period during which the service is provided. The same principle is applied to wealth management, financial planning and custody services that are continuously provided over an extended period of time. Performance linked fees or fee components are recognised when the performance criteria are fulfilled or based on the stage of completion. Other one-off service revenues and other revenues are recognised on an accrual basis at the moment of executing the respective transaction.

**Fee and commission expenses** are recognised after the service has been received and when the liability has incurred.

Interest income and expense is recognised in the statement of profit or loss for all financial instruments carried at amortised cost using the effective interest method or for debt securities measured at fair value through profit or loss. Transaction costs of debt securities measured at fair value through profit or loss is recognised as part of effective interest method. Loan commitment fees that are directly related with the undrawn portion of the loan commitment and which changes based on the portion of the unused commitment are recognised as interest income during the period when draw down is available.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group estimates cash flows considering all contractual terms of the financial instrument, but does not consider future impairment losses. The calculation includes all significant fees paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

When a receivable is impaired, the Group reduces the carrying amount to its recoverable amount, being the estimated future cash flows discounted at the original effective interest rate of the instrument, and continues unwinding the discount as interest income. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

**Dividend income** is recognised when the legal right to receive dividends is established and inflow of economic benefits are probable.

## 2.18 Asset management services

The Group is engaged in providing asset management services (Note 22). Such assets have been given to the Group to be managed by third parties and these assets are recorded off-balance sheet. Service fees are derived from management of such assets and no associated credit and market risks arise for the Group.

## 2.19 Leases - Group as the lessee

Leases of tangible fixed assets where the lessee acquires substantially all the risks and rewards of ownership are classified as finance leases. Other leases are classified as operating leases.

Payments made under operating leases are charged to the statement of profit or loss on a straight-line basis over the lease term. The Group primarily uses an operating lease for renting the premises. A rental expense is recognised in the statement of profit or loss as "Administrative and other operating expenses". In addition, since 1 January 2019 the IFRS 16 Leases will apply to the Group's financial reporting.

IFRS 16, applicable to annual periods beginning on 1 January 2019 or after that date, eliminates the classification of leases as either operating leases or finance leases, as required by IAS 17, and, instead, introduces a single lease accounting model. Impact of IFRS 16 on the financial statements is disclosed in note 2.1 (b).

## 2.20 Taxation and deferred income tax

**Corporate income tax in Estonia**

Estonian companies generally do not pay corporate income tax on profits on a current basis. Tax is paid on distributions of profit, either formal (dividends, other payments from equity) or deemed (non-business expenses, transfer pricing adjustments, certain payments to tax havens, etc.). Dividends and other profit distributions are subject to corporate income tax at the rate of 20/80 on the net amount. Starting from 2019, regular dividend payments will be subject to corporate income tax at the reduced rate of 14/86 to the extent of the average dividend distribution of three preceding years. The first year to be taken account is 2018. Corporate income tax arising from dividend distributions is recorded as a liability and income tax expense when the dividends are declared. The tax becomes due to the tax authorities on the 10th day of the month following the dividend payment.

Starting from second quarter of 2018 credit institutions are obliged to pay advance income tax of 14% on quarterly profits under IFRS. The tax becomes due to the tax authorities on the 10th day of the third month following the quarter. Advance income tax paid is non-refundable and thus recorded as income expense, but can be used to reduce income tax payable on future dividend distributions.

**Corporate income tax in other countries**

In accordance with the local income tax laws, the net profit of companies located in United Kingdom and Lithuania that has been adjusted for the permanent and temporary differences as stipulated by law is subject to corporate income tax.

| Corporate income tax rates | 2018 | 2017 |
|---|---|---|
| Latvia | 20% | 15% |
| Lithuania | 15% | 15% |
| United Kingdom | 19% | 19% |

Deferred income tax is calculated on all significant temporary differences between the tax bases of assets and liabilities and their carrying values in the consolidated statement of financial position. The main temporary differences arise from depreciation and tax loss carry-forwards. Deferred tax balances are measured at tax rates enacted or substantively enacted at the end of the reporting period which are expected to apply to the period when the temporary differences will reverse or the tax loss carry-forwards will be utilised. Deferred tax assets and liabilities are netted only within the individual companies of the Group. Deferred tax assets for deductible temporary differences and tax loss carry-forwards are recorded only to the extent that it is probable that future taxable profit will be available against which the deductions can be utilised. Deferred income tax is provided on temporary differences arising on investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the temporary difference will not reverse in the foreseeable future.

A deferred income tax liability in respect of the Group's available equity which would accompany the payment of available equity as dividends, is not reported in the statement of financial position. The maximum amount of income tax payable, which would arise from paying out the retained earnings as dividends, is disclosed in the Note 21 to the financial statements.

## 2.21 Offsetting

Financial assets and liabilities are offset and the net amount reported in the consolidated statement of financial position only when there is a legally enforceable right to offset the recognized amounts, and there is an intention to either settle on a net basis, or to realize the asset and settle the liability simultaneously. More detailed information in Note 3.10.

## 2.22 Statutory reserve capital

Statutory reserve capital is formed from annual net profit allocations to comply with the requirements of the Commercial Code. During each financial year, at least one-twentieth of the net profit shall be transferred to the statutory reserve, until the reserve reaches one-tenth of share capital. Statutory reserve may be used to cover a loss, or to increase share capital. Payments to shareholders from statutory reserve are not allowed.

## 2.23 Discontinued operations

A discontinued operation is a component of the Group that is classified as held for sale, and represents a separate major line of business or geographical area of operations and is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations. Non-current asset or disposal group is classified as held for sale when their carrying amount is to be covered principally through a sale transaction rather than through continuing use, and the sale is considered highly probable. The disposal group is recognized at carrying amount or fair value less costs related to the transaction of sale, depending on which is lower. Earnings and cash flows of discontinued operations, if any, are disclosed separately from continuing operations with comparatives being re-presented. Intergroup transactions between discontinued and countuing operations are eliminated depending on whether the transactions will continue after the transaction of sale.

## NOTE 3 Risk management

Risk is defined as a potential negative deviation from expected financial results. LHV encounters several risks in its day-to-day operations. The objective of risk management at LHV is to recognise these risks, to measure them appropriately, to manage and to report them. More broadly, the aim of risk management is to increase the value of LHV by minimising losses and reducing the volatility of results. Risk management at LHV is based on a strong risk culture and is built on the principle of three lines of defence where the first line of defence, the business units, are responsible for taking risk and for day-to-day management. The second line of defence, the risk management division, is responsible for the development of risk management methodologies and for the reporting of risks. The third line of defence, the internal audit, conducts independent supervision over the entire group. Risk management principles, requirements and areas of responsibility are described in risk management policy. The principles and objectives of capital management are described in internal documents (capital management policy and capital objectives). More detailed risk management processes are described in the policies of the respective field.

Under the leadership of the Risk Management Unit, LHV has developed a group-wide risk appetite framework, approved by the Supervisory Board. The framework includes quantitative risk tolerance levels by main risks.

**Risk framework**

**Risk management principles, roles and responsibilities**

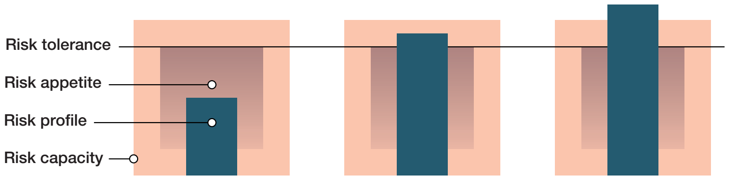
- Risk management and control principles
- Ethics principles
- Remuneration principles
- Organizational structure
- Roles and responsibilities

**Goals, measures and controls**

- Risk tolerance levels
- Measurement of risks
- Rights and limits

**Internal and external reporting, disclosure**

The risk appetite reflects LHV's willingness to take risks in order to achieve its business goals. LHV has defined the limit of the risk appetite as risk tolerance – the maximum level of risk that LHV is willing to take in order to achieve its goals. Risk capacity is defined as the greatest risk that LHV can withstand. The figure on the next page illustrates the three different risk profile levels to levels of risk tolerance and briefly describes the activities in these situations.




The actual risk profile is inside the risk appetite, but below the risk tolerance level. Risk profile is under control and no specific action needed.

The actual risk profile exceeds the risk tolerance level, but is below the risk capacity. An action plan has been launched to reduce the risk profile.

The actual risk exceeds the LHV risk capacity. Financial recovery plan has been launched.

**Risk capacity** – the maximum damage that LHV can withstand. Financial recovery plan has been launched to overcome the risk.

**Risk tolerance** – the maximum risk that LHV is prepared to take to achieve its goals. When exceeding the risk tolerance level the activities at enterprice level will be launched to reduce the risk profile.

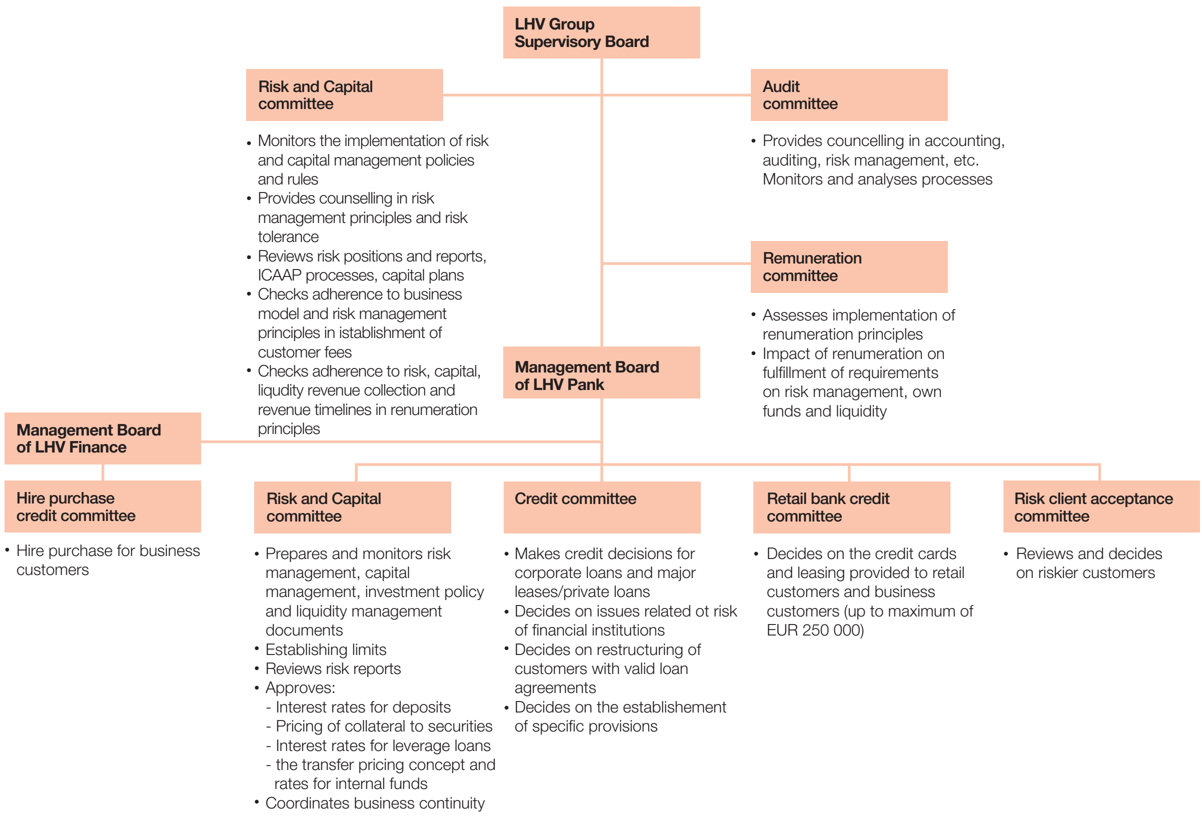
**Risk appetite** is the recommended level of risk that LHV plans to take to implement its plans and goals. Risk appetite reflects the desired risk profile. The maximum risk appetite is defined as a risk tolerance.

**Risk profile** – combination of the real risks of LHV resulting from the nature, scale and complexity of our activities and the operation environment.

As seen from the figure, if the actual risk profile remains within the limits of the risk appetite, it is a foreseeable situation and no further action is needed. If the actual risk profile exceeds the risk tolerance level, an action plan is put in place to reduce the risk profile. It is also necessary to inform the Supervisory Board in that case. The management of LHV risk profile and ensuring it stays within the limits of the risk appetite is the responsibility of the first line of defence, while independent monitoring and reporting is the responsibility of the risk management unit. Within the framework of the financial recovery plan, LHV has developed early warning indicators with thresholds and corresponding measures.

In accordance with risk management policy, the risk tolerance levels must be specified at minimum for capital risk, credit risk, market risk, operation risk, liquidity risk and anti-money laundering risk. The levels of risk tolerance are described in each of the respective risk policies, which are approved at Supervisory Board level. Detailed instructions and guidelines are described in the policies.

LHV has a system of committees and decision-making competencies. The functions of the main committees are shown in the figure below.




As part of the risk policy framework, LHV has developed a risk reporting process. The table below gives an overview of the main reports prepared by the risk management department, which are presented to the governing bodies and their reporting frequency.

| Governing body | Members | Title of the report | Report frequency | Coverage of risks |
|---|---|---|---|---|
| Supervisory board the Group | All the members of the supervisory board of the Group | Risk report | Quarterly | Credit risk, market risk, interest risk, of liquidity risk, operation risk, anti-money laundering risk, monitoring of legislation |
| | | Compliance overview | Monthly | Compliance risk |
| | | ICAAP report, ICAAP macro scenario, SREP report | Once a year | All the risks |
| Supervisory board the Pank | All the members of the supervisory board of the Pank | Risk report | Monthly | Credit risk, market risk, interest risk, of liquidity risk, operation risk, anti-money laundering risk, monitoring of legislation |
| | | Risk management overview | Once a year | All the risks |
| | | ICAAP report, ICAAP macro scenario, SREP report | Once a year | All the risks |
| Risk and Capital Committee of the Group | Rain Lõhmus, Andres Viisemann, Tiina Mõis | Risk report | Quarterly | Credit risk, market risk, interest risk, liquidity risk, operation risk, anti-money laundering risk, monitoring of legislation |
| | | Problematic loan clients | Quarterly | Credit risk |
| Audit committee | Kristel Aarna, Urmas Peiker, Tauno Tats | Risk report | Quarterly | Credit risk, market risk, interest risk, liquidity risk, operation risk, anti-money laundering risk, monitoring of legislation |
| CEO of the Group, Chairman of the Supervisory Board of the Pank | Madis Toomsalu | Risk report | Monthly | Credit risk, market risk, interest risk, The liquidity risk, operation risk, anti-money laundering risk, compliance risk, monitoring of legislation |
| Risk Capital Committee of the Pank | Management board members of the Pank, Tiit Meidla, Romet Enok | Risk report | Monthly | Credit risk, market risk, interest risk, liquidity risk, operation risk, anti-money laundering risk, compliance risk, monitoring of legislation |
| | | Business continuity test and planning | After every test | Operation risks |
| | | Risk self-assessment | After assessment | Operation risks |
| Management Board of the Pank | Management board members of the Pank | Compliance overview | Once in a year | Compliance risks |
| | | Anti-money laundering overview | Once in a year | Anti-money laundering risks |
| | | Monitoring of legislation | Monthly | Compliance risks |
| | | Compliance audit | After every audit | Compliance risks |
| | | ICAAP report, ICAAP macro scenario, SREP report | Once a year | All the risks |

LHV has established a risk management policy, which sets the risk management framework. Separate policies are set for major risk categories. The risks are analysed and monitored and reported to different levels on a monthly and quarterly basis. The risk report, which is compiled on a monthly basis, presents information by type of risk. The risk report also includes information on capital adequacy. It allows getting a regular overview of all the important risks at the company level and to monitor their development, identify bottlenecks, and react promptly.

## 3.1 Capital management

The goal of the Group's capital management is to:

- ensure continuity of the Group's business and ability to generate return for its shareholders;
- maintain a strong capital base supporting the development of business;
- comply with capital requirements as established by supervision authorities.

The Group considers net own funds as capital. The amount of capital that the Group managed as at 31.12.2018 was EUR 183 444 thousand (31.12.2017: EUR 141 609 thousand). The goals of the Group's capital management are set based on both the regulative requirements and additional internal buffer.

The Group follows the general principles in its capital management:

- The Group must be adequately capitalized at all times, having necessary capital to ensure economic preservation and enabling financing of new profitable growth opportunities;
- The main focus of the capital management is on tier 1 own funds, because only tier 1 own funds can absorb losses. All other capital layers in use are dependent of tier 1 own funds volume;
- Capital of the Group can be divided into: 1) regulated minimum capital and 2) capital buffer held by the Group. In order to reach its long-term economic goals the Group must on one hand strive towards proportional lowering of the regulated minimum capital (through minimizing risks and high transparency). On the other hand, the Group must strive towards sufficient and conservative capital reserve, which will ensure economic preservation even in the event of severe negative risk scenario;
- The risk appetite set by the Group is an important input to capital management planning and capital goal setting. Higher risk appetite requires maintaining higher capital buffer.

**Own funds**

| *(in thousands of euros)* | 31.12.2018 | 31.12.2017 |
|---|---|---|
| Paid-in share capital | 26 016 | 25 767 |
| Share premium | 46 653 | 46 304 |
| Statutory reserves transferred from net profit | 3 451 | 2 471 |
| Other reserves | 78 | 36 |
| Accumulated profit/(deficit) | 50 193 | 24 468 |
| Intangible assets (subtracted) | -19 084 | -7 940 |
| Net profit for accounting period | 25 237 | 19 603 |
| **Total Tier 1 own funds** | **132 544** | **110 709** |
| Subordinated debt | 50 900 | 30 900 |
| **Total Tier 2 own funds** | **50 900** | **30 900** |
| **Total net own funds** | **183 444** | **141 609** |

The net capital of a credit institution at any time shall be equal to or exceed the minimum amount of share capital prescribed in the Credit Institutions Act (EUR 5 million). In 2014, the capital of banks and investment firms in the European Union became subject to a legal framework (CRD IV/CRR), largely based on the Basel III framework that was agreed in the Basel Committee on Banking Supervision. The objective of the framework is to strengthen the resilience of the financial sector to adverse economic shocks and thereby ensure an adequate and sustainable financing of the economy. Significant changes implemented by the new requirements include the requirement for credit institutions to maintain a higher level and quality of capital than before and a unified framework for designing liquidity buffers. The capital requirements directive also define measures for macro-financial supervision that member states can use to control the behaviour of credit institutions in amplifying the cycles and to alleviate risks arising from market structure.

The regulation, which is directly applicable in the member states, obligates all credit institutions operating in the European Union (including their consolidating holding companies) and investment firms to maintain 4.5% of Common Equity Tier 1 (CET 1) and 6.0% of Tier 1 Capital against risk assets. The overall Capital Adequacy Requirement (CAD), including both Tier 1 and Tier 2 capital, remains at the existing 8.0% level.

In addition to the main requirements based on uniform rules, the directive defines the principles for forming capital buffers. In Estonia, in addition to the baseline capital requirements, credit institutions have been subjected to capital maintenance and systemic risk buffers, which are 2.5% (imposed by the Financial Supervisory Authority), 1.0% (imposed by Estonian Central Bank) and systematically importance buffer (imposed by Financial Supervisory Authority), respectively. In 2018 the grouping of capital requirements changed and SREP buffers were moved to higher capital buffers, meaning that first bank will breach other buffers before SREP buffers. Breaching each buffer triggers different actions from regulators side and first one in list is set by Estonian Central Bank triggering limitation of ECB transactions.

The latter is also subject to the specific supplementary Pillar 2 requirement applicable to credit institutions. An overview of capital requirements is provided in the table below:

| **Requirements** | CET1 | Tier 1 | CAD |
|---|---|---|---|
| Base capital requirement | 4.50% | 6.00% | 8.00% |
| Pillar 2 capital charge | 0.39% | 0.52% | 1.53% |
| Non-resident financial intermediates deposits* | 0.28% | 0.28% | 0.28% |
| Total SREP capital requirement | 5.17% | 6.80% | 9.81% |
| Capital conservation buffer | 2.50% | 2.50% | 2.50% |
| Systemically importance buffer | 1.00% | 1.00% | 1.00% |
| Systemic risk buffer | 1.00% | 1.00% | 1.00% |
| Contra cyclical buffer | 0.00% | 0.00% | 0.00% |
| **Capital requirements total** | **9.67%** | **11.30%** | **14.31%** |

* Capital charge is volatile and calculated as 0.2% from non-resident financial intermediates deposits. Here volumes in financial plan is used for ratio calculation

| | CET1 | Tier 1 | CAD |
|---|---|---|---|
| Capital requirements valid from August 2017* | 7.92% | 9.42% | 11.42% |
| Capital requirements valid from October 2016* | 8.00% | 9.50% | 11.50% |

* In addition to base requirement Pillar II requirement and systematically importance requirement were separately added. Starting from mid 2018 all these components are inside capital requirements.

Capitalization levels have been increased not due to riskiness of the bank, but because of the increasing market share of the bank. In 2018 LHV was considered as one of four systematically important bank in Estonia. This decision has increased capital buffers by 0.5% from 1st of July 2018 and by another 0.5% from 1st of January 2019. LHV has been keeping conservative approach in capital management and keeps additional internal buffers compared to regulatory ones.

Internal capital adequacy targets for 2019 are as follows:

- Core Tier 1 capital adequacy 10.40% (10.49% in 2018)
- Tier 1 capital adequacy 12.10% (12.21% in 2018)
- Total capital adequacy 15.50% (15.06% in 2018)
- Leverage ratio 3.50% (not changed)
- MREL ratio 6.08% (not changed)

Each year, the Group's supervisory board confirms the goals of capitalization and the target level of capital adequacy to cover potential risks arising from fast growth. Each year, an internal capital adequacy assessment process (ICAAP) is performed, the goal of which is to identify potential internal capital needs in addition to regulatory capital requirements.

Capital adequacy and the use of regulatory capital are monitored by the Finance Department. Reports about the compliance with prudential and capital requirements for covering the risks are submitted regularly to supervision authorities. LHV uses standard method for calculating capital requirements for credit and market risk and basic indicator approach calculating operational risk capital requirement.

The own funds of LHV Varahaldus as the fund manager need at any given time exceed the minimum amount of share capital laid down in the Investment Funds Act (EUR 3 million). Starting from January 10th 2017, the net own funds of a fund manager have to be 0.5% of the market value of managed pension funds with the market value less than EUR 1 billion and 0.02% of the market value of managed pension funds with the market value more than EUR 1 billion. The Group and its subsidiaries have complied with all capital requirements during the financial year and in previous years.

## 3.2 Credit risk

Credit risk is the risk of suffering financial loss, should any of the Group's customers, clients or market counterparties fail to fulfil their contractual obligations to the Group. Credit risk arises from cash and cash equivalents, derivatives and deposits with banks and other financial institutions, debt securities, but mainly from credit exposures to customers, including outstanding loans, given guarantees, other receivables and commitments.

Credit risk is one of the largest risk for the Group's business; management therefore carefully manages its exposure to credit risk. In order to evaluate credit risk, Group analyses the operations and financial position of its customers and business partners. After approving the credit, the solvency of the customer and the value of the collateral are regularly monitored. The credit risk management and control are centralised in a credit risk management unit which reports regularly to the Management Board and Supervisory Board.

### 3.2.1 Distribution of credit risks

The Group classifies the financial assets exposed to credit risk in the following key categories:

a) due from central bank and credit institutions (referred to as "banks" in the tables) and investment companies

b) debt securities and derivatives

c) leveraged loans (loans secured by debt or equity securities)

d) corporate credit portfolio, including
- loans and overdrafts
- financial guarantees
- warehouse financing
- factoring
- leasing
- unused loan commitments

e) retail credit portfolio, including
- mortgage loans (home and private loans)
- consumer loans without collateral
- hire-purchase
- credit cards and overdrafts to individuals
- leasing
- retail loans and overdrafts to SMEs
- financial guarantees to SMEs
- unused loan commitments

**Maximum exposure to credit risk**

| *(in thousands of euros)* | Note | 31.12.2018 | 31.12.2017 |
|---|---|---|---|
| Due from banks and investment companies | 10 | 682 658 | 961 212 |
| Available for sale financial assets | 11a | 0 | 555 |
| Debt instruments at FVOCI | 11b | 298 | 0 |
| Financial assets at fair value (debt securities) | 12 | 38 458 | 49 168 |
| Loans and advances to customers | 13 | 918 761 | 732 043 |
| Receivables from customers | 14 | 3 721 | 9 800 |
| Other financial assets | 15 | 2 936 | 2 289 |
| **Total financial assets** | | **1 646 832** | **1 755 067** |
| Exposures related to off-balance sheet items, excluding performance guarantees | 23 | 198 210 | 185 622 |
| **Total maximum exposure to credit risk** | | **1 845 042** | **1 940 689** |

### 3.2.2 Credit risk measurement

For all loan products, except leverage loans, LHV uses either rating or scoring systems to assess customer credit risk, as outlined in the table below. All credit products have application models, whose outputs are used for making credit decisions. There are also portfolio scoring models developed and models to cover the dimensions of Loss Given Default (LGD) and Credit Conversion Factor (CCF).

| Portfolio | Segment | Definition | PD | LGD | CCF/EAD |
|---|---|---|---|---|---|
| Corporate | Corporate exposures | Loans to companies with total exposure to LHV >= EUR 250,000 | Rating system | Model | Model or fix. parameter |
| Retail | SME, incl. micro enterprises | Loans to companies with total exposure to LHV < EUR 250,000 | Scoring models | | |
| | Private mortgage | All mortgage loans to private individuals | Scoring models | | |
| | Private consumer | All consumer financing products and car leasing to private individuals | Scoring models | | |

### (a) Due from banks and investment companies

Management estimates that the credit risk exposure from cash and cash equivalents, held at the central bank, other correspondent banks and investment institutions has inherently low credit risk. Loans and advances to central bank, credit institutions and investments companies are not overdue, and are also unsecured. The funds of the Group according to ratings given by Standard & Poor's or equivalent (central bank without a rating). In case there are ratings available from more than one rating agency, the average, or the most conservative rating is used. The positions are held as follows:

**Rating**
*(in thousands of euros)*

| | Credit institutions | Investment companies | Total 31.12.2018 | Credit institutions | Investment companies | Total 31.12.2017 |
|---|---|---|---|---|---|---|
| Central bank (The Bank of Estonia) | 639 862 | 0 | 639 862 | 920 714 | 0 | 920 714 |
| AA- to AA+ | 209 | 0 | 209 | 2 321 | 0 | 2 321 |
| A- to A+ | 11 352 | 0 | 11 352 | 8 856 | 0 | 8 856 |
| BBB to BBB+ | 5 661 | 16 505 | 22 166 | 6 294 | 14 116 | 20 410 |
| B to B+ | 0 | 500 | 500 | 0 | 0 | 0 |
| Non-rated | 8 569 | 0 | 8 569 | 8 841 | 70 | 8 911 |
| **Total (Note 10)** | **665 653** | **17 005** | **682 658** | **947 026** | **14 186** | **961 212** |

Non-rated credit institutions are local Estonian or subsidiaries of large EU banks or financial institutions without external credit rating, however management considers their credit quality to be good based on available market information. Management has assessed that the ECL from credit institutions and investment companies exposures is immaterial due to the strong ratings of corresponding parties, their financial position and also due to the positive economic outlook in short-term perspective, as the Group holds only very liquid positions with the counterparties. See also note 3.2.4.3 for additional information.

### (b) Debt securities and derivatives

The Credit Committee sets limits for taking credit risk associated with debt securities considering the issuer's rating. The Risk Capital Committee or authorised employees make decisions regarding investments within the limits set.

No principal and accrued interest receivables arising from debt securities are overdue. The bonds have no collateral.

The Group´s derivatives, debt securities at fair value through profit or loss (FVTPL) and available-for-sale (AFS) or fair value through other comprehensive income (FVOCI) according to ratings given by Standard & Poor's or equivalent:

**Ratings distribution**
*(in thousands of euros)*

| | Mandatory FVTPL | | | | | |
|---|---|---|---|---|---|---|
| | Investment portfolio | Liquidity portfolio | Trading portfolio | Foreign exchange forwards | FVOCI | Total 31.12.2018 |
| AAA | 0 | 18 439 | 0 | 0 | 0 | 18 439 |
| A- to A+ | 18 006 | 0 | 0 | 0 | 0 | 18 006 |
| AA- to AA+ | 0 | 1 229 | 0 | 0 | 0 | 1 229 |
| Non-rated | 0 | 0 | 1 023 | 59 | 0 | 1 082 |
| **Total (Note 11,12)** | **18 006** | **19 668** | **1 023** | **59** | **0** | **38 756** |

**Ratings distribution**
*(in thousands of euros)*

| | FVTPL | | | | | |
|---|---|---|---|---|---|---|
| | Investment portfolio | Liquidity portfolio | Trading portfolio | Foreign exchange forwards | AFS | Total 31.12.2017 |
| AAA | 0 | 29 869 | 0 | 0 | 0 | 29 869 |
| A- to A+ | 18 223 | 0 | 1 046 | 0 | 555 | 19 824 |
| Non-rated | 0 | 0 | 0 | 30 | 0 | 30 |
| **Total (Note 11,12)** | **18 223** | **29 869** | **1 046** | **30** | **555** | **49 723** |

Debt securities classified as FVTPL is based on the management assessment of the instrument's business model and how management monitor these investments. Therefore, fair value through profit or loss measurement basis was applied at the application of IFRS 9 as at 1 January 2018.

Debt securities classified as FVOCI was based on the management assessment of the instrument's business model. Therefore, fair value through other comprehensive income measurement basis was applied at the application of IFRS 9 as at 1 January 2018. During 2018, these investments were disposed and the year end balance is 0 euros.

### (c) Other receivables

**Credit quality of other receivables**
*(in thousands of euros)*

| | 31.12.2018 | 31.12.2017 |
|---|---|---|
| Receivables (not overdue) | 3 498 | 9 392 |
| Receivables (overdue) | 223 | 408 |
| incl. receivables from individuals | 196 | 215 |
| incl. receivables from legal entities | 27 | 193 |
| **Total** (Note 14) | **3 721** | **9 800** |

As at 11 February 2019, other receivables of EUR 205 thousand euros are uncollected and in previous years, the Group has not written off any receivables. Other financial assets (see Note 15) in amount EUR 2 936 thousand (31.12.2018: EUR 2 289 thousand) are guarantee deposits on the Baltic stock exchanges held to guarantee securities trading activity on the stock exchanges of Tallinn, Riga and Vilnius and the deposits of VISA and MasterCard to guarantee credit card transactions. The Group considers the counterparties credit risk as very low.

### (d) Leveraged loans

The Bank issues margin loans secured by debt or equity securities to its customers, i.e. financial leverage. The maximum amount of the loan depends on the market value of the assets held as collateral in the investment account, and on the general limit set by the Bank, which is currently EUR 100 thousand (or an equivalent in a foreign currency) per customer. Granting loans above the threshold assumes an analysis of the overall financial situation of the client and the portfolio offered as collateral by the customer and the decision is within the competence of the Credit Committee. The Group has set sufficiently conservative limits to the ratio of the loan and the collateral assets value. The list of acceptable marketable financial instruments and the levels of the required collateral are published on the Bank's website www.lhv.ee.

### (e) Corporate credit portfolio

Corporate credit portfolio customers are evaluated on individual basis. Each customer is assigned a credit rating between 1 and 13, where 1 means the lowest probability of default and 13 indicates insolvency. Credit rating is assigned to a customer considering combination of financial status and business risk.

The specific financial ratios and business risk aspects considered depend on the rating model used: corporate, commercial real estate, residential development, and commodity. Credit rating is assigned by credit analyst and confirmed by Head of Credit Analysis Department, but final decision of risk taking is the unanimous decision by the Credit Committee.

After issuing the loan, follow-up monitoring is performed at least quarterly for each customer's financial position. At least annually all client ratings are reviewed. Clients with significant increase in credit risks are listed in watchlist.The financial position, liquidity and collateral value of watchlist clients is thoroughly monitored more frequently. See Note 3.2.4. for more detailed information on the credit quality of loans.

### (f) Retail loans to SME´s

In 2016, the Group started offering micro loans. The loan is aimed to micro enterprises in the growth stage and the maximum loan amount is up to EUR 25 000.

In addition to micro loans, the retail banking segment also includes other corporate credit commitments in the amount of up to EUR 250 thousand. Credits below EUR 250 thousand are analysed with a more cost-efficient scoring process. The scoring process is carried out at the time of loan application and it is one of the criteria for issuing the loan.

Financial data and information on payment behaviour of the company is used when calculating the probability of default (PD). The structure of assets and liabilities are taken into account, also the profitability and cash flow ratios.

Retail loans of legal entities are included in the retail loans financial statement line item.

See Note 3.2.4. for more detailed information on the credit quality of loans.

#### (g) Consumer loans without collateral and hire-purchase

Group offers consumer loans and hire-purchase through its subsidiary LHV Finance in Estonia. The maximum loan amount is up to EUR 15 000 and hire purchase up to EUR 20 000. Hire purchase service is offered through merchant partners. Scoring model are used to assess the customer's credit behaviour. The scoring is made at the time the application is filed and is one of the criteria for issuing a credit.

The Group has entered into agreements where most overdue consumer loans and hire purchase agreements are sold – usually when loans reaching overdue at least of 79 days.

See Note 3.2.4. for more detailed information on the credit quality of loans.

#### (h) Credit cards

The Bank issues credit cards and Partner credit cards in cooperation with Tallinna Kaubamaja. Similarly to consumer loans and hire purchase most overdue loans are sold when overdues breach 79 days.

See Note 3.2.4. for more detailed information on the credit quality of loans.

#### (i) Student loans

In 2018, the Group started offering student loans. The loan is aimed to students to cover costs during their studies. The maximum amount of state secured student loan is EUR 2 000 per academic year.

See Note 3.2.4. for more detailed information on the credit quality of loans.

#### (j) Mortgage loans

In 2013, Group started to offer on a limited basis mortgage loans (private loans) to customers in the Tallinn and Tartu region only. In autumn 2016, Group started offering the mortgage loan (home loans) to a large scale of retail clients without regional limits within Estonia. The maximum loan amount is in line with the regulations set by Central Bank of Estonia.

See Note 3.2.4. for more detailed information on the credit quality of loans.

#### (k) Leasing

The Bank offers leasing products for individuals and legal entities. The creditworthiness of customers is assessed by using a rating model for clients with exposure of more than EUR 250 thousand and scoring models for clients with exposure of less than EUR 250 thousand. Rating model is the same which used for assessment of creditworthiness of corporate credit portfolio customers.

See Note 3.2.4. for more detailed information on the credit quality of loans.

### Risk concentration

Several tolerance limits that are regularly monitored and reported have been introduced in Group's Credit Policy to control and hedge concentration risk. These limits are set for overall credit portfolio and separately for the largest – corporate credit portfolio. The most significant metrics and limits measured at the last day of each quarter are as follows:

a) The share of small financing in the Group's total credit portfolio
b) The share of financing non-domicile customers in the Group's total credit portfolio
c) The share of shadow banking financing compared to net owned funds
d) The share of ten largest credit customers compared to net owned funds
e) The share of financing the higher risk rating classes compared to the total corporate credit portfolio
f) The share of financing the catering and construction sector compared to the total corporate credit portfolio
g) Th share of financing outside of Estonia (incl. financing in EU countries and UK).

Distribution of assets and liabilities by geographic region is presented below. As at 31.12.2018, the loans issued to 8 customers (2017: total 8) had a large risk exposure, i.e. more than 10% of the net own funds (NOF) of Group either individually or via group risk, totalling 111% of NOF (2017: 111%).

The Group has invested in the debt securities of 2 issuers (2017: 2) with a large risk exposure, totalling 21% of NOF (2017: 33%). Of customer deposits, the deposits of 3 (2017: 3) customers have a high risk concentration, which amounts to 89% (2017: 425%) of NOF. Group has drastically reduced the larger depositor's volumes and replaced these deposits with retail deposits. There are 6 clients holding more than 1% of all deposits (2017: 4). Their total deposits amount was EUR 189 million (2017: 615). Share of Top 20 depositors was 20.5% as of 31.12.2018 compared to more than 50% as end of 2017.

**31.12.2018**

*(in thousands of euros)*

| | Note | Estonia | Latvia | Lithuania | Finland | Netherlands | Germany | Other EU | USA | Other | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Due from banks and investment companies | 10 | 650 321 | 0 | 0 | 0 | 0 | 0 | 13 599 | 16 541 | 2 197 | **682 658** |
| Financial assets at fair value | 11, 12 | 8 392 | 772 | 17 242 | 0 | 0 | 1 | 20 704 | 43 | 0 | **47 154** |
| Loans and advances to customers | 13 | 886 881 | 52 | 10 561 | 1 524 | 1 | 6 | 18 432 | 175 | 1 129 | **918 761** |
| Receivables from customers | 14 | 3 706 | 1 | 5 | 0 | 0 | 0 | 0 | 0 | 9 | **3 721** |
| Other financial assets | 15 | 111 | 0 | 0 | 0 | 0 | 0 | 0 | 2 825 | 0 | **2 936** |
| **Total financial assets** | | **1 549 411** | **825** | **27 808** | **1 524** | **1** | **7** | **52 735** | **19 584** | **3 335** | **1 655 230** |
| Deposits from customers and loans received | 17 | 1 154 012 | 10 041 | 951 | 3 414 | 576 | 13 274 | 220 173 | 3 085 | 38 256 | **1 443 782** |
| Subordinated debt | 20 | 50 900 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | **50 900** |
| Accounts payable and other financial liabilities | 18 | 21 381 | 0 | 4 | 27 | 0 | 0 | 13 | 3 | 0 | **21 428** |
| Financial liabilities at fair value | 12 | 11 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | **11** |
| **Total financial liabilities** | | **1 226 304** | **10 041** | **955** | **3 441** | **576** | **13 274** | **220 186** | **3 088** | **38 256** | **1 516 121** |

**31.12.2017**

*(in thousands of euros)*

| | Note | Estonia | Latvia | Lithuania | Finland | Netherlands | Germany | Other EU | USA | Other | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Due from banks and investment companies | 10 | 919 599 | 47 | 2 528 | 0 | 0 | 0 | 3 051 | 28 152 | 7 835 | **961 212** |
| Financial assets at fair value | 11, 12 | 7 466 | 779 | 17 456 | 0 | 0 | 29 867 | 1 064 | 2 | 0 | **56 634** |
| Loans and advances to customers | 13 | 650 871 | 3 644 | 46 269 | 998 | 91 | 42 | 26 580 | 45 | 3 503 | **732 043** |
| Receivables from customers | 14 | 8 481 | 372 | 947 | 0 | 0 | 0 | 0 | 0 | 0 | **9 800** |
| Other financial assets | 15 | 109 | 0 | 0 | 0 | 0 | 0 | 0 | 2 180 | 0 | **2 289** |
| **Total financial assets** | | **1 586 526** | **4 842** | **67 200** | **998** | **91** | **29 909** | **30 695** | **30 379** | **11 338** | **1 761 978** |
| Deposits from customers and loans received | 17 | 848 642 | 5 024 | 825 | 2 717 | 12 505 | 632 | 639 608 | 2 855 | 30 121 | **1 542 929** |
| Subordinated debt | 20 | 30 900 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | **30 900** |
| Accounts payable and other financial liabilities | 18 | 60 382 | 3 047 | 3 360 | 27 | 0 | 0 | 13 | 3 | 0 | **66 832** |
| Financial liabilities at fair value | 12 | 2 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | **2** |
| **Total financial liabilities** | | **939 926** | **8 071** | **4 185** | **2 744** | **12 505** | **632** | **639 621** | **2 858** | **30 121** | **1 640 663** |

**Distribution of loans granted by industry (gross):**
*(in thousands of euros)*

| | 31.12.2018 | % | 31.12.2017 | % |
|---|---|---|---|---|
| Individuals | 214 702 | 23.1% | 191 744 | 25.9% |
| Real estate | 246 930 | 26.6% | 197 697 | 26.7% |
| Manufacturing | 98 073 | 10.6% | 68 252 | 9.2% |
| Art and entertainment | 34 582 | 3.7% | 29 292 | 4.0% |
| Financial services | 95 697 | 10.3% | 78 113 | 10.6% |
| Wholesale and retail | 24 378 | 2.6% | 21 112 | 2.9% |
| Administrative activities | 39 808 | 4.3% | 33 947 | 4.6% |
| Transport and logistics | 11 076 | 1.2% | 5 876 | 0.8% |
| Agriculture | 20 231 | 2.2% | 8 717 | 1.2% |
| Other servicing activities | 25 669 | 2.8% | 15 485 | 2.1% |
| Construction | 35 808 | 3.9% | 19 421 | 2.6% |
| Information and communication | 4 115 | 0.4% | 8 439 | 1.1% |
| Professional, scientific and technical activities | 18 779 | 2.0% | 13 958 | 1.9% |
| Education | 2 391 | 0.3% | 2 218 | 0.3% |
| Other areas at activities | 56 798 | 6.1% | 45 897 | 6.2% |
| **Total** (Note 13) | **929 037** | **100%** | **740 168** | **100%** |

**Loans and advances (incl. loan commitments and guarantees)**

The estimation of credit exposure for risk management purposes is complex and requires the use of models, as the exposure varies with changes in market conditions, expected cash flows and the passage of time. The assessment of credit risk of a portfolio of assets entails further estimations as to the likelihood of defaults occurring, of the associated loss ratios and of default correlations between counterparties. The Group measures credit risk using Probability of Default (PD), Exposure at Default (EAD) and Loss Given Default (LGD). This is similar to the approach used for the purposes of measuring Expected Credit Loss (ECL) under IFRS 9. Refer to note 3.3.2 for more details.

**Credit risk grading**

The Group uses internal credit risk grading that reflect the assessment of the probability of default of individual counterparties. The Group use internal rating models tailored to the various categories of counterparty. Borrower and loan specific information collected at the time of application (such as disposable income, and level of collateral for retail exposures; and turnover and industry type for wholesale exposures) is fed into this rating model. This is supplemented with external data such as credit bureau scoring information on individual borrowers. In addition, the models enable expert judgement from the Credit Risk Officer to be fed into the final internal credit rating for each exposure. This allows for considerations which may not be captured as part of the other data inputs into the model.

The credit grades are calibrated such that the risk of default increases exponentially at each higher risk grade. For example, this means that the difference in the PD between rating grade 4 and 5 is lower than the difference in the PD between a 7 and 8.

The following are additional considerations for each type of portfolio held by the Group:

**Retail**

After the date of initial recognition, for retail business, the payment behaviour of the borrower is monitored on a periodic basis to develop a behavioural score. Any other known information about the borrower which impacts their creditworthiness – such as unemployment and previous delinquency history – is also incorporated into the behavioural score. This score is mapped to a PD.

**Corporate**

For corporate business, the rating is determined at the borrower level. A relationship manager will incorporate any updated or new information/credit assessments into the credit system on an ongoing basis. In addition, the relationship manager will also update information about the creditworthiness of the borrower every year from sources such as public financial statements. This will determine the updated internal credit rating and PD.

**Treasury**

For debt securities in the Treasury portfolio, the credit standing of the security is determined on the basis of the ratings of external rating agencies. These ratings are continuously monitored and updated. The PD's associated with each rating are mapped to LHV's rating scale.

As LHV doesn't have a significant market risk portfolio then LHV measures concentration in other two key areas: liquidity risk and credit risk.

**Liquidity Risk**

As LHV keeps its liquid assets mainly in cash in ECB then concentration risk in liquidity risk concerns mostly funding risks. 98% of LHV funding is in the form of deposits and therefore the most important metrics to measure concentration risk concerning liquidity is deposit concentration (Note 3.2.2. Risk concentration).

**Credit Risk**

The Group's rating method used for evaluating the PD of corporate loans consists of a total of 13 credit ratings where 1 stands for the lowest and 13 for the highest credit risk. Ratings 1 and 2 are attributed only based on average ratings of rating agencies Fitch, Moody's and Standard & Poor's, and are subject to the Group's financial analysis as necessary.

The master scale assigns each rating category a specified range of probabilities of default, which is stable over time.

Thus, ratings 1 and 2 are attributed only to international enterprises, organisations, local governments and countries whose solvency has been confirmed by the rating agencies with their investment grade rating. Also rating classes 3 -13 are partly based on the evaluation of rating agencies, although this category includes mainly Estonian enterprises that do not have an international rating.

The group's internal rating scale for corporate loans and mapping of external ratings:

**LHV rating**

| | LHV description | PD% | S&P | Moody's |
|---|---|---|---|---|
| 1 | Investment grade | 0.03 | AAA | Aaa |
| 2 | | 0.05 | AA+ | Aa1 |
| 3 | | 0.10 | AA, AA- | Aa2, Aa3 |
| 4 | | 0.20 | A+,A,A- | A1,A2,A3 |
| 5 | | 0.30 | BBB+ | Baa1 |
| 6 | | 0.40 | BBB | Baa2 |
| 7 | | 0.50 | BBB- | Baa3 |
| 8 | | 1.00 | BB+,BB | Ba1,Ba2 |
| 9 | | 2.50 | BB- | Ba3 |
| 10 | Non-investment grade | 5.00 | B+ | B1 |
| 11 | | 10.00 | B,B- | B2,B3 |
| 12 | | 30.00 | CCC/C | Caa |
| 13 | Default | 100.00 | D | C |

The rating methods are subject to an annual validation and recalibration so that they reflect the latest projections in the light of all actually observed defaults.

All retail loans have a behavioural score. This score is mapped to a PD. Retail loans are divided into three groups: investment grade, special monitoring and default. Investment grade is allocated when the loan is not overdue as at balance sheet date. Special monitoring status is allocated when the loan has overdue status and default status is based on the definition of default principle.

## 3.2.3 Expected credit loss measurement

IFRS 9 outlines a 'three-stage' model for impairment based on changes in credit quality since initial recognition as summarised below:

A financial instrument that is not credit-impaired on initial recognition is classified in 'Stage 1' and has its credit risk continuously monitored by the Group.

If a significant increase in credit risk ('SICR') since initial recognition is identified, the financial instrument is moved to 'Stage 2' but is not yet deemed to be credit-impaired. Please refer to note 3.2.3.1 for a description of how the Group determines when a significant increase in credit risk has occurred.

If the financial instrument is credit-impaired, the financial instrument is then moved to 'Stage 3'. Please refer to note 3.2.3.2 for a description of how the Group defines credit-impaired and default.

Financial instruments in Stage 1 have their ECL measured at an amount equal to the portion of lifetime expected credit losses that result from default events possible within the next 12 months. Instruments in Stages 2 or 3 have their ECL measured based on expected credit losses on a lifetime basis. Please refer to note 3.2.3.3 for a description of inputs, assumptions and estimation techniques used in measuring the ECL.

A pervasive concept in measuring ECL in accordance with IFRS 9 is that it should consider forward-looking information. Note 3.2.3.4 includes an explanation of how the Group has incorporated this in its ECL models.

Purchased or originated credit-impaired financial assets are those financial assets that are credit-impaired on initial recognition. Their ECL is always measured on a lifetime basis (Stage 3).

The following diagram summarises the impairment requirements under IFRS 9 (other than purchased or originated credit-impaired financial assets):

**Change in credit quality since initial recognition**

| Stage 1 | Stage 2 | Stage 3 |
|---|---|---|
| (Initial recognition) | (Significant increase in credit risk since initial recognition) | (Credit-impaired assets) |
| 12-month expected credit losses | Lifetime expected credit losses | Lifetime expected credit losses |

The key judgements and assumptions adopted by the Group in addressing the requirements of the standard are discussed below.

### 3.2.3.1 Significant increase in credit risk

The Group considers a financial instrument to have experienced a significant increase in credit risk when one or more of the following quantitative, qualitative or backstop criteria have been met:

**Quantitative criteria**

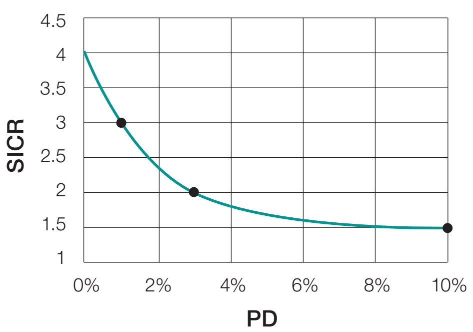
Quantitative criteria is applied to all credit contracts initiated in 2018 in the current portfolio and Wholesale legacy portfolio, for which a rating based Lifetime PD is used.

The remaining Lifetime PD at the reporting date has increased, compared to the residual Lifetime PD expected at the reporting date when the exposure was first recognised, so that it exceeds the relevant threshold per the table below:

*Current portfolio – contracts initiated from 1st January 2018*

| Lifetime PD band at initial recognition | Increase in Lifetime PD at reporting date which is considered significant |
|---|---|
| X% | ≥100 bps |
| *And* | Current PD_life/Initial PD_life > 1.4885+exp(0,9549-54,173*Initial PD_life) |

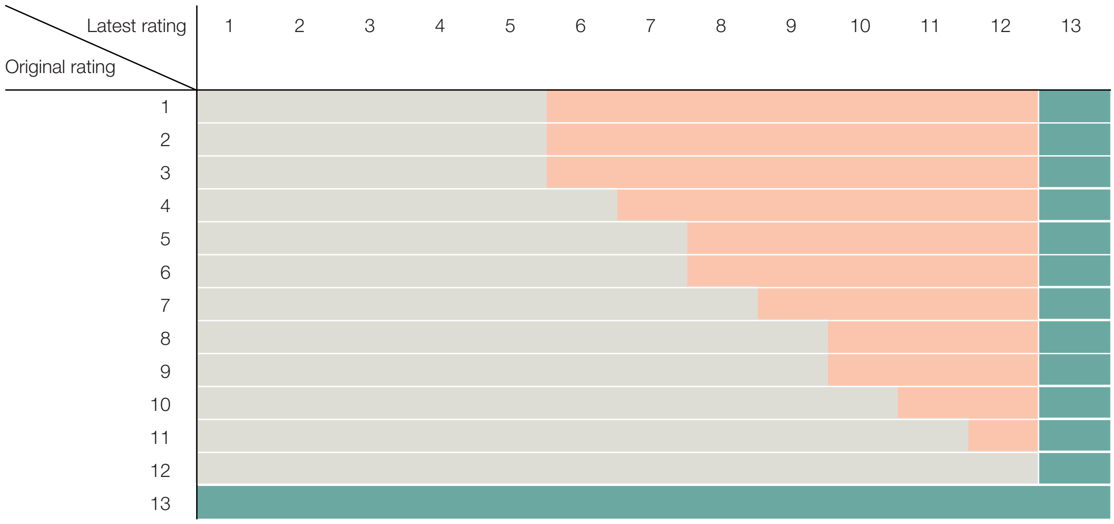
To illustrate the formula, see SICR curve graphic below. In addition to the curve, the PD increase has to be at least 100 bps.




SICR curve: Relation between the Origination PD and the significance threshold (PD increase in number of times) for identifying significant increase in default risk

To illustrate the application of these thresholds, take for example a 3-year retail business loan agreement initiated on 13th February 2018 which at initial recognition had a Lifetime PD of 3.36 % and was expected to have a residual Lifetime PD of 2.76% ten months later at the current reporting date. If at the current reporting date the loan has a current lifetime PD of 8.86% then this exceeds the expected PD of 2.76% by more than the threshold shown above. Therefore a significant increase in credit risk has occurred.

Legacy portfolio – corporate contracts initiated before 1st January 2018




These thresholds have been determined by assessing how the Lifetime PD moves prior to an instrument becoming delinquent. The Lifetime PD movements on instruments which do not subsequently become delinquent have also been assessed, to identify the „natural" movement in Lifetime PD, which is not considered indicative of a significant increase in credit risk. The average maturity of the corporate portfolio is short, namely 2.7 years.

**Qualitative criteria**

Qualitative criteria is applied in SICR calculation to legacy retail portfolio that was initiated before 2018. For the current portfolio, the qualitative criteria is included in the PD calculation and therefore included in the SICR calculation through Lifetime PD.

Due to the average short maturity of the legacy portfolio (1.75 years)  it was not practical to go back to history to predict initial PDs for the contracts initiated before the of 1st December, 2017 and therefore the application PD or rating PD were used as initial PDs for legacy portfolio.

Retail legacy portfolio – private person contracts initiated before 1st January 2018

If the borrower meets one or more of the following conditions, then there is significant increase in credit risk:

- At the report date the contract is over 30 days past due with more than 10 euros
- The contract has been overdue over 30 days and in the amount of more than 10 euros more than once over the last 12 months or
- The customer has had more than one payment alert or tax debt over the last 12 months
- In case of home or private loan the contract LTV >100% is also considered.

Retail legacy portfolio – business contracts initiated before 1st January 2018

If the borrower meets one or more of the following conditions, then there is significant increase in credit risk:

- At the report date the contract is over 30 days past due with more than 10 euros
- The contract has been overdue over 30 days and in the amount of more than 10 euros more than once over the last 12 months or

- The customer has had more than one payment alert or has had at least four incidents of tax debt in the amount of over 640 euros over the last 12 months.

The assessment of SICR incorporates forward-looking information (see note 3.2.3.4. for further information) and is performed on a quarterly basis. The criteria used to identify SICR are monitored and reviewed periodically for appropriateness by the independent member of Credit Risk team.

**Backstop**

A backstop is applied and the financial instrument considered to have experienced a significant increase in credit risk if the borrower is more than 30 days past due on its contractual payments.

The Group has used the low credit risk exemption for cash and nostro accounts fulfilling the liquidity portfolio criteria in the year ended 31 December 2018.

The following tables show the impact on the 31 December 2018 ECL allowance of changing the PD thresholds for SICR. Increases in ECL (positive amounts) represent higher impairment allowances that would be recognised.

| **Product** *(in thousands of euros)* | +10% Change in SICR | -10% Change in SICR |
|---|---|---|
| Leveraged loans | NA | NA |
| Corporate loans | NA | NA |
| Retail loans to SMEs | 0 | 0 |
| Consumer loans | -3 | 3 |
| Hire-purchase | 0 | 0 |
| Credit cards | 0 | 1 |
| Mortgage loans | 0 | 0 |
| Private loans | 0 | 0 |
| Leasing | 0 | 0 |

| **Product** *(in thousands of euros)* | SICR with 0.5% threshold | SICR with 1.5% threshold |
|---|---|---|
| Leveraged loans | NA | NA |
| Corporate loans | NA | NA |
| Retail loans to SMEs | 0 | 0 |
| Consumer loans | 0 | 0 |
| Hire-purchase | 0 | 0 |
| Credit cards | 0 | 0 |
| Mortgage loans | 0 | 0 |
| Private loans | 0 | 0 |
| Leasing | 0 | 0 |

As evidenced by above tables, changing SICR by +/- 10% or chagning the 100bps treshold to 50bps or 150bps have limited impact to the overall ECL of the Group.

### 3.2.3.2 Definition of default and credit-impaired assets

The Group defines a financial instrument as in default, which is fully aligned with the definition of credit-impaired, when it meets one or more of the following criteria:

**Quantitative criteria**

The borrower is more than 90 days and over 10 euros past due on its contractual payments. The threshold of 10 euros is put in place with debt management procedures that is a trigger for debt collection activities and also indicated as materiality threshold in Definition of Default.

**Qualitative criteria**

The borrower meets unlikeliness to pay criteria, which indicates the borrower is in significant financial difficulty. The following circumstances are considered as indicators for the customer not to pay the debt in full:

- Non-accrued status is applied to the contract
- Specific credit adjustments has been formed due to the decline in the credit quality
- Sale of credit obligation with economic loss higher than 5 %
- Distressed restructuring measures have been applied to the contract resulting with diminished financial obligation higher than 1 %

- It is becoming probable that the borrower will enter bankruptcy or has filed for bankruptcy
- a customer's resources of cash flow are no longer available to meet the payments of instalments
- The Group has called any collateral including a guarantee.

The criteria above have been applied to all financial instruments held by the Group and are consistent with the definition of default used for internal credit risk management purposes. The default definition has been applied consistently to model the Probability of Default (PD), Exposure at Default (EAD) and Loss given Default (LGD) throughout the Group's expected loss calculations.

For applying the default status a customer based approach is used for wholesale and contract based approach is used for the retail portfolio.

An instrument is considered to no longer be in default when it no longer meets any of the default criteria for the probation period of corresponding to the reason of default. The shortest probation period of three months is applied to the contracts that defaulted due to filling the quantitative criteria from the date the criteria is no longer met.

Loans under distressed restructuring are considered to require particular attention in the reclassification to non-defaulted status because the assessment of days past due is based on the modified payment arrangement and the exposure cannot stop being restructured by the time it is fully repaid. Therefore the probation period for these loans is defined as at least 1 year from the latter of:

- the moment of extending the restructuring measures;
- the moment when the exposure has been classified as defaulted; or
- the end of grace period included in the restructuring arrangements.

### 3.2.3.3 Measuring ECL - Explanation of inputs, assumptions and estimation techniques

The aim of the ECL model is to calculate the 12-month and lifetime expected credit losses that:

- are unbiased, i.e. do not include any conservatism or optimism;
- are probability-weighted amounts that are determined by evaluating three provisioning scenarios (base scenario, upside scenario and downside scenario);
- reflect the time value of money;
- use reasonable and supportable information about past events, current conditions and forecasts of future economic conditions.

The Group's ECL model follows widely accepted sum of marginal losses approach, whereby ECLs are calculated as the sum of the marginal losses occurring in each time period (month) from the reporting date. The marginal losses are derived from individual risk parameters (PD, LGD, EAD) that estimate exposures and losses in the case of default and the marginal probability of default for each period (the probability of a default in time period X conditional upon an exposure having survived to time period X).

**ECL calculations are based on four components:**

Probability of Default (PD) is an estimate of the likelihood of default over a given time horizon.

Exposure at Default (EAD) is an estimate of the exposure at a future default date, taking into account expected changes in the exposure after the reporting date, including repayments of principal and interest, and expected drawdowns on committed facilities.

Loss Given Default (LGD) is an estimate of the loss arising on default. It is based on the difference between the contractual cash flows due and those that LHV would expect to receive, including from any collateral. LGD is expressed as a percentage of the EAD.

Discount factor is used to discount an expected loss to a present value at the reporting date.

Mathematically, the ECL amount for prediction horizon T (12 months or lifetime, depending on whether 12-month or lifetime ECL estimates are concerned) is expressed as follows:

$$ECL_T = \sum_{t=1} PD_t * LGD_t * EAD_t * d_t$$

Where:

| | |
|---|---|
| *t = 0,…,T* | *– a one month period within the prediction horizon T; for a 12-month ECL estimate, T = 12 months; for a lifetime ECL estimate, T = expected life of the lending exposure;* |
| *PDt* | *– marginal PD for month t;* |
| *LGDt* | *– LGD as estimated for month t;* |
| *EADt* | *– exposure amount, incl. expected drawdowns of undrawn commitments, at month t;* |
| *dt* | *– discount factor for month t.* |

The discount rate represents the effective interest rate ("EIR") for the financial instrument or an approximation thereof.

A simplified example of the calculation logic is illustrated in table below. Note that in this example for secured loans, LGD is directly derived from the collateral value and as a simplification, fair value is assumed to be constant. However, ECL model takes into account the possible decrease of collateral fair value over time through different scenarios.

| | 31/01/2018 | 28/02/2018 | 31/03/2018 | 30/04/2018 | 31/05/2018 | 30/06/2018 | 31/07/2018 | 31/08/2018 | 30/09/2018 |
|---|---|---|---|---|---|---|---|---|---|
| (1) Exposure (EAD) | 4000 | 3500 | 3000 | 2500 | 2000 | 1500 | 1000 | 500 | 0 |
| (2) Marginal PD | 0.40% | 0.38% | 0.36% | 0.34% | 0.32% | 0.30% | 0.28% | 0.26% | 0.24% |
| (3) Collateral value | 2000 | 2000 | 2000 | 2000 | 2000 | 2000 | 2000 | 2000 | 2000 |
| (4) Potential loss amount [Max (0;1-3)} | 2000 | 1500 | 1000 | 500 | 0 | 0 | 0 | 0 | 0 |
| (5) Expected marginal loss [2*4] | 8 | 5.7 | 3.6 | 1.7 | 0 | 0 | 0 | 0 | 0 |
| (6) Expected marginal loss, discounted | 7.97 | 5.65 | 3.56 | 1.67 | 0 | 0 | 0 | 0 | 0 |
| Lifetime ECL at 31.12.2017 [Sum(6)] | 18.85 | | | | | | | | |

Note. Discounting is done, assuming current reporting date 31.12.2017 and a 5% discount rate.

For the defaulted exposures, ECL is computed as:

$$ECL_T = \sum_{t=1} LGD_t * Exposure_t * d_t$$

Each of the risk dimensions (PD, LGD, EAD) is covered with the internally developed rating- and scoring models. These models have been developed for the business- and credit management.

As can be concluded, the key issue in ECL modelling is to transform the available risk parameter values into forward looking PiT estimates and 'feed' them into the expected credit loss calculation formula.

**IFRS 9 parameters**

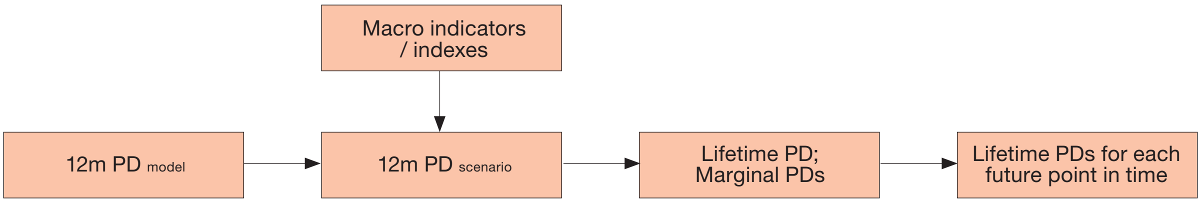
| | |
|---|---|
| **Definition of Default** | • 90 days past due<br>• Unlikely to pay without the bank turning to recourses such as selling collateral |
| **PD** | • 12-month PD; lifetime PD broken down further into marginal probabilities for sub-periods<br>• Forward looking PiT estimate, reflecting assessment of current and future economic conditions, and a range of possible future outcomes<br>• No regulatory floors or margins of conservatism applied |
| **LGD** | • Neutral PiT projections<br>• Consider current and future economic conditions, and a range of possible future outcomes<br>• Recoveries discounted, using EIR as discount rate<br>• No regulatory floors or margins of conservatism applied |
| **CCF/EAD** | • Reflects expected changes in the balance outstanding over the lifetime of the lending exposure, incl. scheduled loan payments and prepayments |
| **ECL** | • PV of cash shortfalls. For Stage 1 exposures, 12-month PD is used. For stage 2 exposures, lifetime PD is used. For Stage 3 exposures, PD = 100% |

The following paragraphs outline how the existing underlying models are leveraged off for the ECL measurement. Each risk dimension in detail is discussed in the following chapters.

#### 3.2.3.3.1 'Feeding' PDs from underlying rating and scoring models into ECL model

Instead of the historically based or long run average 12-month PDs (model PDs), forward looking 12-month and lifetime PiT estimates and marginal PDs are required for the IFRS 9 expected credit loss calculation.

The transformation of the model PD (PDmodel) is performed in the following flow:




Firstly, model PD is re-calibrated to the forward looking 12-month PiT estimate, given the defined macro scenario (12m PDscenario). Selected macro indicators, transformed into macro indexes, serve as inputs for this purpose.

Next, forward looking 12-month PiT estimate is converted to lifetime PD and marginal PDs. This is done using the segment-specific standard default curve which gives the timing of the expected defaults for the remaining life of an exposure.

Lastly, lifetime PDs for each of the future points in time till the end of the expected life of the exposure are calculated.

#### 3.2.3.3.2 'Feeding' LGDs from underlying models into ECL model

In LGD dimension, the use of the underlying LGD models differs for secured and unsecured lending exposures.

As IFRS 9 parameter should take into account the expected drop in the exposure amount over time, LGD for the secured part of the secured loans is directly calculated from the estimated fire-sale price of the collateral; no input from the underlying LGD models is used.

LGDs from the underlying LGD models 'feed' into the ECL calculation for the unsecured exposures and unsecured parts of the secured exposures.

Further, macroeconomic scenarios are incorporated into both secured and unsecured LGDs as applicable for the defined provisioning scenarios.

#### 3.2.3.3.3 'Feeding' CCF estimates from underlying models into ECL model

Internal CCF estimates feed directly to the ECL model and are used in the EAD. No further adjustments are needed for the CCF as the internal estimates do not include margins of conservatism, or through the cycle (TtC) or downturn adjustments.

### 3.2.3.4 Forward-looking information incorporated in the ECL model

In order to incorporate forward looking information into the ECL measurements and capture a range of possible outcomes for the future conditions, probability-weighted ECL amounts based on the three provisioning scenarios (base, upside and downside) are calculated. Among others, this approach enables to reflect non-linear relationships between alternative scenarios and the ECL.

Mathematically:

$$ECL = p_{base} * ECL_{base} + p_{up} * ECL_{up} + p_{down} * ECL_{down}$$

Where:

| | |
|---|---|
| pbase, pup, pdown | – probabilities of the base, upside and downside scenarios respectively; |
| ECLbase, ECLup, ECLdown | – expected credit loss amounts calculated for each of the defined scenarios. |

ECLs for each of the defined scenarios are derived based on the general formula, using scenario specific risk parameter values. Probability-weighted lifetime PD estimates for the purpose of assessing significant increase in credit risk are calculated in the same way:

$$PD = p_{base} * PD_{base} + p_{up} * PD_{up} + p_{down} * PD_{down}$$

Where:

| | |
|---|---|
| PDbase, PDup, PDdown | – lifetime PD estimates corresponding to each of the defined scenarios |

#### 3.2.3.4.1 Selected indicators for private person credit portfolios

Selected macro indicators for private person credit portfolios and relative importance of each of the indicators are shown in table below:

| | Mortgage | Consumer financing, fixed rate | Consumer financing, floating (incl. leasing) |
|---|---|---|---|
| Wage growth, % | 17% | 22% | 18% |
| Unemployment rate, % | 33% | 44% | 36% |
| Houseprice index growth, % | 8% | 0% | 0% |
| Inflation rate, % | 8% | 11% | 9% |
| Euribor, 6m | 17% | 0% | 18% |
| Bank lending margins | 17% | 22% | 18% |
| TOTAL | 100% | 100% | 100% |

Note. Relative importance of each of the indicators is calculated based on the indicator 'weights'.

#### 3.2.3.4.2 Selected indicators for companies

A wide range of macroeconomic and industry sector-specific indicators was considered for companies. The analysis was conducted based on the two industry breakdowns:

1) broad industry sector level based on letter codes / alphabetical branch of the NACE Rev.2 classification, and

2) sub-sectors based on lower level numerical codes of the NACE Rev.2 classification.

The following conclusions were drawn from the analysis:

All sectors have been affected by the same credit cycle and have experienced major sector-wide financial difficulties at the same time. Despite of that, there are certain idiosyncratic differences between the industry sub-sectors e.g. in manufacturing

There are only a few variables that 'work'; the variables that have explanatory power, tend to 'work' similarly for most of the industry sectors:

GDP growth which explains the general state of economy,

Change in turnover,

Change in number of persons employed.

Change in an industry sector's profit/loss was also tested, but tends to be too volatile for drawing conclusions on substantial change in default risk.

A few macro indicators are significant to certain industry sectors, sub-sectors and/or groupings of sub-sectors even if correlations are difficult to show due to low numbers of observations and/or because of relatively short observation period. E.g.:

Export conditions for export-oriented industries such as: metal products, chemical products and electrical equipment;

Population growth and income growth for residential real estate;

Household consumption growth for industries that are oriented to internal consumption such as retail trade.

In conclusion, gross value added by industry sectors was selected as the indicator for companies, this given several considerations:

Observed correlation with the considered proxies for default rates;

GDP, which is close indicator to the gross value added, is the preferred approach for the industry;

It is easier to project for a macro economist than alternative indicators.

**Economic variable assumptions**

Macoreconomic scenarios (forecasts) and its indicators (incl. corporate portfolio PD and LGD estimates) are developed at least once a year and which are developed internally in the Credit Management Department that consults with the experts from Risk Control Unit, business, finance and external experts.

Macro developments are monitored on a quarterly basis as new macroeconomic data becomes available. Forecasts are updated as necessary in order to ensure timely inclusion of new forward-looking information into the ECL estimates.

Developed provisioning scenarios and significant updates to the scenarios are approved in the Risk and Capital Committee.

The most significant period-end assumptions used for the ECL estimate as at 31 December 2018 are set out below. The scenarios "base", "upside" and "downside" were used for all portfolios.

**Valid at 31.12.2018**

| | Base scenario | | Downside scenario | | Upside scenario | |
|---|---|---|---|---|---|---|
| **General macro-financial indicators** | **2019E** | **2020E** | **2019E** | **2020E** | **2019E** | **2020E** |
| Real GDP growth, % | 3.0% | 2.9% | 1.0% | 0.9% | 4.0% | 3.9% |
| Household consumption, % | 3.9% | 3.0% | 2.0% | 1.0% | 4.5% | 3.5% |
| Government consumption, % | 0.8% | 0.7% | 0.7% | 0.6% | 1.2% | 1.0% |
| Gross fixed capital formation, % | 4.4% | 4.2% | 2.0% | 1.9% | 8.0% | 8.0% |
| Exports of goods and services, % | 3.8% | 3.8% | 0.5% | 0.3% | 4.3% | 4.3% |
| Imports of goods and services, % | 4.0% | 3.9% | 1.0% | 0.7% | 4.8% | 4.8% |
| Nominal GDP, EURm | 27 051 | 28 614 | 26 161 | 26 919 | 27 722 | 29 875 |
| GDP deflator, % change | 3.2% | 2.8% | 2.5% | 2.0% | 3.9% | 3.7% |
| Consumer price growth, % | 3.0% | 2.6% | 2.1% | 1.7% | 3.5% | 3.5% |
| Unemployment rate, % | 4.6% | 4.5% | 5.5% | 5.9% | 4.5% | 4.5% |
| Change in employment, % | 0.8% | -0.1% | 0.0% | -0.3% | 1.1% | 0.3% |
| Net monthly wage growth, % (nominal) | 6.0% | 5.2% | 3.0% | 2.5% | 7.5% | 6.0% |
| House price index growth, % | 3.4% | 3.2% | -4.0% | -4.1% | 4.4% | 4.2% |
| Euribor 6m | -0.2% | 0.2% | -0.2% | 0.2% | -0.1% | 0.3% |
| Bank lending margins on new loans | 2.0% | 2.0% | 2.3% | 2.5% | 2.0% | 2.0% |

| **Nominal growth** | Base scenario | | Downside scenario | | Upside scenario | |
|---|---|---|---|---|---|---|
| **Gross value added by sectors, y-o-y growth rates** | **2019E** | **2020E** | **2019E** | **2020E** | **2019E** | **2020E** |
| Total - all NACE activities | 6.3% | 5.7% | 3.5% | 3.1% | 8.0% | 7.8% |
| Agriculture, forestry and fishing | 10.0% | 10.0% | 5.0% | 5.0% | 14.0% | 14.0% |
| Industry (except construction) | 5.0% | 4.3% | 2.8% | 2.2% | 6.2% | 5.5% |
| Industry, except construction and manufacturing (mostly energy related) | 5.0% | 3.0% | 4.8% | 2.8% | 6.0% | 4.0% |
| Manufacturing | 5.0% | 4.7% | 2.1% | 2.0% | 6.3% | 6.0% |
| Construction | 9.0% | 5.0% | -6.0% | -4.0% | 12.0% | 11.0% |
| Wholesale and retail trade, transport, accomodation and food service activities | 5.0% | 4.8% | 1.5% | 0.5% | 6.5% | 6.5% |
| Information and communication | 14.1% | 14.0% | 14.1% | 14.0% | 15.8% | 15.8% |
| Financial and insurance activities | 6.0% | 6.0% | 3.5% | 3.5% | 9.0% | 9.0% |
| Real estate activities | 3.3% | 3.3% | -1.0% | -5.0% | 3.8% | 3.8% |
| Professional, scientific and technical activities; administrative and support service activities | 7.0% | 6.0% | 5.0% | 4.0% | 9.0% | 8.0% |
| Public administration, defence, education, human health and social work activities | 6.0% | 6.0% | 9.0% | 9.0% | 8.0% | 8.0% |
| Arts, entertainment and recreation; other service activities; activities of household and extra-territorial organizations and bodies | 7.0% | 6.5% | 4.5% | 4.0% | 9.0% | 8.5% |

The weightings assigned to each economic scenario at 31 December 2018 were as follows:

**Valid at 31.12.2018**

| | Base scenario | Downside scenario | Upside scenario |
|---|---|---|---|
| Weights of economic scenarios | 65% | 25% | 10% |

The most significant period-end assumptions used for the ECL estimate as at 1 January 2018 are set out below. The scenarios "base", "upside" and "downside" were used for all portfolios.

**Valid at 01.01.2018**

| | Base scenario | | Downside scenario | | Upside scenario | |
|---|---|---|---|---|---|---|
| **General macro-financial indicators** | **2018E** | **2019E** | **2018E** | **2019E** | **2018E** | **2019E** |
| Real GDP growth, % | 2.5% | 2.5% | 0.4% | 0.4% | 3.8% | 3.8% |
| Household consumption, % | 3.0% | 3.0% | 2.0% | 2.0% | 4.0% | 4.0% |
| Government consumption, % | 1.0% | 1.0% | 1.0% | 1.0% | 2.0% | 2.0% |
| Gross fixed capital formation, % | 6.0% | 6.0% | 0.0% | 0.0% | 8.0% | 8.0% |
| Exports of goods and services, % | 5.0% | 5.0% | 2.0% | 2.0% | 7.0% | 7.0% |
| Imports of goods and services, % | 6.0% | 6.0% | 3.0% | 3.0% | 8.0% | 8.0% |
| Nominal GDP, EURm | 24 434 | 25 949 | 23 621 | 24 297 | 24 832 | 26 804 |
| GDP deflator, % change | 3.8% | 3.6% | 2.5% | 2.5% | 4.2% | 4.0% |
| Consumer price growth, % | 3.3% | 3.3% | 2.0% | 2.0% | 3.5% | 3.5% |
| Unemployment rate, % | 5.4% | 5.4% | 6.0% | 7.0% | 5.0% | 5.0% |
| Change in employment, % | 0.2% | 0.0% | 0.0% | 0.0% | 0.5% | 0.5% |
| Net monthly wage growth, % (nominal) | 6.0% | 6.0% | 4.0% | 4.0% | 7.0% | 7.0% |
| House price index growth, % | 3.0% | 3.0% | -10.0% | -10.0% | 5.0% | 5.0% |
| Euribor 6m | -0.3% | -0.1% | -0.3% | -0.3% | -0.2% | 0.0% |
| Bank lending margins on new loans | 1.8% | 1.8% | 2.4% | 2.6% | 1.8% | 1.8% |

| Nominal growth | Base scenario | | Downside scenario | | Upside scenario | |
|---|---|---|---|---|---|---|
| **Gross value added by sectors, y-o-y growth rates** | **2018E** | **2019E** | **2018E** | **2019E** | **2018E** | **2019E** |
| Total - all NACE activities | 6.3% | 6.4% | 2.8% | 3.1% | 8.2% | 8.2% |
| Agriculture, forestry and fishing | 1.8% | 2.0% | -9.1% | 0.3% | 5.4% | 5.7% |
| Industry (except construction) | 11.9% | 8.0% | 6.5% | 4.5% | 14.7% | 9.5% |
| Industry, except construction and manufacturing (mostly energy related) | 10.0% | 9.6% | 10.2% | 10.0% | 11.8% | 11.4% |
| Manufacturing | 7.4% | 7.5% | 0.4% | 2.5% | 10.4% | 8.9% |
| Construction | 2.5% | 2.3% | -10.0% | -10.0% | 4.2% | 5.6% |
| Wholesale and retail trade, transport, accomodation and food service activities | 6.2% | 6.9% | 2.4% | 2.4% | 8.4% | 9.1% |
| Information and communication | 10.6% | 10.2% | 10.6% | 10.2% | 12.4% | 12.0% |
| Financial and insurance activities | 7.4% | 8.4% | -2.5% | -5.2% | 10.4% | 11.3% |
| Real estate activities | 3.0% | 3.0% | -5.0% | -5.0% | 5.0% | 5.0% |
| Professional, scientific and technical activities; administrative and support service activities | 7.2% | 7.0% | 2.4% | 2.4% | 9.0% | 7.7% |
| Public administration, defence, education, human health and social work activities | 6.2% | 5.9% | 13.8% | 10.4% | 6.7% | 6.7% |
| Arts, entertainment and recreation; other service activities; activities of household and extra-territorial organizations and bodies | 6.2% | 5.9% | 2.4% | 2.4% | 6.4% | 6.1% |

The weightings assigned to each economic scenario at 1 January 2018 were as follows:

**Valid at 01.01.2018**

| | Base scenario | Downside scenario | Upside scenario |
|---|---|---|---|
| Weights of economic scenarios | 65% | 25% | 10% |

Other forward-looking considerations not otherwise incorporated within the above scenarios, such as the impact of any regulatory, legislative or political changes, have also been considered, but are not deemed to have a material impact and therefore no adjustment has been made to the ECL for such factors. This is reviewed and monitored for appropriateness on a quarterly basis in Risk and Capital Committee.

**Sensitivity analysis**

The most significant assumptions affecting the ECL allowance are as follows:

Retail portfolio

- Unemployment rate
- Wage growth
- Euribor
- Bank lending margins
- GDP

Corporate portfolio

- Estimated portfolio PiT PD values for each scenario
- Estimated LGD impact on downside scenario

The table below illustrates the impact of changing scenario weights of positive and negative scenarios to the portfolio as it was at 31 December 2018.

| *(in thousands of euros)* | 65-5-30 | 65-15-20 |
|---|---|---|
| | (base/up/down) | (base/up/down) |
| Change in scenario weights | 265 | -265 |

Set out below are the changes to the ECL as at 31 December 2018 that would result from reasonably possible changes in these parameters from the actual assumptions used in the Group's economic variable assumptions (for example, the impact on ECL of increasing the estimated unemployment rate by X% in each of the base, upside, downside scenarios):

*(in thousands of euros)*

| | Impact of increase | Impact of decrease |
|---|---|---|
| Unemployment rate +/-1% | 37 | -24 |
| Wage growth +/- 5% | -35 | 27 |
| Euribor +/-0.5% | 1 | -1 |
| Bank lending margins +/-0.5% | 62 | -50 |
| Consumer price growth +/-1% | -13 | 8 |
| House price index +/- 2% | 0 | 0 |
| Gross value added by sectors, yoy growth rates +/- 5% | -24 | 27 |

The Group has performed stress test scenarios when PD and LGD estimations will both increase by 0.5. The impact of the described stress test to impairments is aggregated in the table below. The table includes loans, which have collective impairment and which have material balances and potential impact.

*(in thousands of euros)*

| | Impact on loss allowances |
|---|---|
| LGD negative 0.88 | 260 |
| LGD negative 1.0 | -246 |
| Average PiT PD -0.5% | -843 |
| Average PiT PD +0.5% | 814 |

### 3.2.4 Credit risk exposure

#### 3.2.4.1 Maximum exposure to credit risk – Financial instruments subject to impairment

The following tables contain an analysis of the credit risk exposure of financial instruments for which an ECL allowance is recognised. The gross carrying amount of financial assets below also represents the Group's maximum exposure to credit risk on these assets.

Information on how the Expected Credit Loss (ECL) is measured and how the three stages above are determined is included in note 3.2.3. „Expected credit loss measurement“.

**Corporate Credit portfolio**

As at 31.12.2018, the group-based impairment reserve makes up 1.4% of corporate loans and overdraft and the related interest receivables (31.12.2017: 0.5%).

**Distribution of corporate loans and overdraft by internal ratings 31.12.2018**

| *(in thousands of euros)* | Total | Grading |
|---|---|---|
| 4 low credit risk | 1 162 | |
| 5 low credit risk | 31 936 | |
| 6 low credit risk | 103 019 | |
| 7 medium credit risk | 155 855 | |
| 8 medium credit risk | 180 376 | |
| 9 heightened credit risk | 116 164 | Investment grade |
| 10 high credit risk | 38 407 | |
| 11 high credit risk | 3 121 | |
| 12 non-satisfactory rating | 5 807 | Special monitoring |
| 13 insolvent | 12 425 | Default |
| **Total** | **648 271** | |

In very limited cases, customer's with rating in investment grade are selected for special monitoring. There were no such customers as at 31.12.2018.

**2018 ECL staging**

| *(in thousands of euros)* | Stage 1 12-month ECL | Stage 2 Lifetime ECL | Stage 3 Lifetime ECL | Purchased or Initiated Credit Impaired | Total |
|---|---|---|---|---|---|
| **Credit grade** | | | | | |
| Investment grade | 471 744 | 603 | 0 | 0 | **472 348** |
| Special monitoring | 135 723 | 27 775 | 0 | 0 | **163 498** |
| Default | 0 | 0 | 12 045 | 380 | **12 425** |
| **Gross carrying amount** | 607 468 | 28 378 | 12 045 | 380 | **648 271** |
| Loss allowances | 1 973 | 1 107 | 5 486 | 186 | **8 751** |
| **Carrying amount** | 605 495 | 27 272 | 6 560 | 194 | **639 520** |

For off-balance sheet exposures related with corporate credit portfolio, a provision of EUR 128 thousand was recorded as of 31.12.2018.

**Corporate factoring**

As at 31.12.2018, the group-based impairment reserve makes up 3.3% of corporate factoring portfolio and the related interest receivables.

**2018 ECL staging**

| *(in thousands of euros)* | Stage 1 12-month ECL | Stage 2 Lifetime ECL | Stage 3 Lifetime ECL | Purchased or Initiated Credit Impaired | Total |
|---|---|---|---|---|---|
| **Credit grade** | | | | | |
| Investment grade | 2 654 | 0 | 0 | 0 | **2 654** |
| Special monitoring | 0 | 412 | 0 | 0 | **412** |
| Default | 0 | 0 | 0 | 0 | **0** |
| **Gross carrying amount** | 2 654 | 412 | 0 | 0 | **3 067** |
| Loss allowances | 21 | 79 | 0 | 0 | **100** |
| **Carrying amount** | 2 633 | 333 | 0 | 0 | **2 966** |

**Retail loans**

As at 31.12.2018, the group-based impairment reserve makes up 1.1% of retail loans and related claims (31.12.2017: 1.1%). Credit decision is done by the majority decision of the Retail Banking Credit Committee.

**Retail loans to SMEs**

**2018 ECL staging**

| *(in thousands of euros)* | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased or Initiated Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Credit grade** | | | | | |
| Investment grade | 14 966 | 1 043 | 0 | 0 | **16 009** |
| Special monitoring | 0 | 0 | 0 | 0 | **0** |
| Default | 0 | 0 | 191 | 0 | **191** |
| **Gross carrying amount** | 14 966 | 1 043 | 191 | 0 | **16 200** |
| Loss allowances | 31 | 54 | 98 | 0 | **184** |
| **Carrying amount** | 14 935 | 988 | 93 | 0 | **16 016** |

For off-balance sheet exposures related with retail credit portfolio, a provision of EUR 19 thousand was recorded as of 31.12.2018.

**Private loans**

**2018 ECL staging**

| *(in thousands of euros)* | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased or Initiated Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Credit grade** | | | | | |
| Investment grade | 35 248 | 2 516 | 0 | 0 | **37 764** |
| Special monitoring | 0 | 0 | 0 | 0 | **0** |
| Default | 0 | 0 | 146 | 16 | **163** |
| **Gross carrying amount** | 35 248 | 2 516 | 146 | 16 | **37 927** |
| Loss allowances | 8 | 0 | 1 | 0 | **10** |
| **Carrying amount** | 35 239 | 2 516 | 145 | 16 | **37 917** |

**Student loans**

**2018 ECL staging**

| *(in thousands of euros)* | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased or Initiated Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Credit grade** | | | | | |
| Investment grade | 76 | 0 | 0 | 0 | **76** |
| Special monitoring | 0 | 0 | 0 | 0 | **0** |
| Default | 0 | 0 | 0 | 16 | **0** |
| **Gross carrying amount** | 76 | 0 | 0 | 0 | **76** |
| Loss allowances | 0 | 0 | 0 | 0 | **0** |
| **Carrying amount** | 76 | 0 | 0 | 0 | **76** |

### Consumer loans

PD and LGD values are updated at least once a year with new historical data in order to maintain adequate provision levels on portfolio. If necessary, additional impairments will be made in the statement of financial position. If non-performing or doubtful loan recovery is neither economical nor practical to continue, the loan is written off as irrecoverable.

As at 31.12.2018, the group-based impairment reserve makes up 1.7% of consumer loans and the related interest receivables (31.12.2017: 3.4%).

**2018 ECL staging**

| *(in thousands of euros)* | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased or Initiated Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Credit grade** | | | | | |
| Investment grade | 29 427 | 4 372 | 0 | 0 | **33 799** |
| Special monitoring | 0 | 0 | 0 | 0 | **0** |
| Default | 0 | 0 | 190 | 0 | **190** |
| **Gross carrying amount** | 29 427 | 4 372 | 190 | 0 | **33 989** |
| Loss allowances | 213 | 267 | 88 | 0 | **568** |
| **Carrying amount** | 29 214 | 4 105 | 102 | 0 | **33 421** |

For off-balance sheet exposures related with consumer credit portfolio, a provision of EUR 0 thousand was recorded as of 31.12.2018.

### Hire purchase

Similarly, to other homogenous portfolios, provisions are made based on the same framework as consumer loans.

As of 31 December 2018, the group-based impairment reserve amounted to 0.8% of hire-purchase portfolio (31.12.2017: 1.2%).

**2018 ECL staging**

| *(in thousands of euros)* | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased or Initiated Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Credit grade** | | | | | |
| Investment grade | 16 507 | 1 191 | 1 | 0 | **17 699** |
| Special monitoring | 0 | 0 | 0 | 0 | **0** |
| Default | 0 | 1 | 50 | 0 | **51** |
| **Gross carrying amount** | 16 507 | 1 192 | 51 | 0 | **17 750** |
| Loss allowances | 55 | 46 | 39 | 0 | **140** |
| **Carrying amount** | 16 452 | 1 146 | 12 | 0 | **17 610** |

### Credit cards

Provisions for potential credit losses are made based on the same framework as the consumer loans. The framework is based on PD, LGD and EAD indicators. As of 31 December 2018, the group-based impairment reserve amounted to 0.4% of credit card loans and related receivables (31.12.2017: 1.9%).

**2018 ECL staging**

| *(in thousands of euros)* | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased or Initiated Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Credit grade** | | | | | |
| Investment grade | 6 221 | 605 | 7 | 0 | **6 833** |
| Special monitoring | 1 | 7 | 0 | 0 | **7** |
| Default | 1 | 10 | 2 | 0 | **12** |
| **Gross carrying amount** | 6 223 | 621 | 9 | 0 | **6 853** |
| Loss allowances | 6 | 18 | 3 | 0 | **27** |
| **Carrying amount** | 6 217 | 603 | 6 | 0 | **6 826** |

For off-balance sheet exposures related with credit cards portfolio, a provision of EUR 1 thousand was recorded as of 31.12.2018.

**Mortgage loans**

The provisions are made based on the same framework as for consumer loans. As of 31 December 2018, the group-based impairment amounted to 0.03% of mortgage portfolio (31.12.2017: 0.3%).

**2018 ECL staging**

| *(in thousands of euros)* | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased or Initiated Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Credit grade** | | | | | |
| Investment grade | 93 158 | 7 851 | 0 | 0 | **101 009** |
| Special monitoring | 0 | 0 | 0 | 0 | **0** |
| Default | 0 | 0 | 0 | 0 | **0** |
| **Gross carrying amount** | 93 158 | 7 851 | 0 | 0 | **101 009** |
| Loss allowances | 19 | 7 | 0 | 0 | **26** |
| **Carrying amount** | 93 139 | 7 844 | 0 | 0 | **100 983** |

**Leasing**

The leasing provisioning is done based on Leasing scoring models. The provisions are made based on the same framework as for consumer loans. As of 31 December 2018, the group-based impairment reserve amounted to 0.8% of leasing portfolio (31.12.2017: 0.3%).

**2018 ECL staging**

| *(in thousands of euros)* | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased or Initiated Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Credit grade** | | | | | |
| Investment grade | 53 810 | 3 874 | 0 | 0 | **57 684** |
| Special monitoring | 0 | 2 198 | 0 | 0 | **2 198** |
| Default | 0 | 0 | 284 | 0 | **284** |
| **Gross carrying amount** | 53 810 | 6 071 | 284 | 0 | **60 165** |
| Loss allowances | 92 | 312 | 63 | 0 | **467** |
| **Carrying amount** | 53 717 | 5 760 | 221 | 0 | **59 698** |

**Levaraged loans**

The Bank had no impaired leveraged loans as at 31.12.2018 and 31.12.2017.

The impairment reserve amounted to 0.08% of the leveraged loans portfolio

**2018 ECL staging**

| *(in thousands of euros)* | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased or Initiated Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Credit grade** | | | | | |
| Investment grade | 3 730 | 0 | 0 | 0 | **3 730** |
| Special monitoring | 0 | 0 | 0 | 0 | **0** |
| Default | 0 | 0 | 0 | 0 | **0** |
| **Gross carrying amount** | 3 730 | 0 | 0 | 0 | **3 730** |
| Loss allowances | 3 | 0 | 0 | 0 | **3** |
| **Carrying amount** | 3 726 | 0 | 0 | 0 | **3 726** |

### 3.2.4.2 Credit quality of financial assets as of 31.12.2017

**Credit quality of loans and advances to customers and off-balance sheet liabilities**

**Loans and advances to customers 31.12.2017**

| *(in thousands of euros)* | Neither past due nor impaired | Past due, but not impaired | Individually impaired | Total | Collective impairment | Individual impairment | Net |
|---|---|---|---|---|---|---|---|
| **Loans to legal entities** | | | | | | | |
| Corporate loans | 443 822 | 3 766 | 9 160 | **456 748** | -2 161 | -1 518 | **453 069** |
| Retail loans | 13 049 | 581 | 26 | **13 656** | -155 | 0 | **13 501** |
| Overdraft | 34 309 | 0 | 4 883 | **39 192** | -122 | -793 | **38 277** |
| Hire-purchase | 268 | 0 | 1 | **269** | -3 | -1 | **265** |
| Leveraged loans | 4 547 | 0 | 0 | **4 547** | 0 | 0 | **4 547** |
| Leasing | 31 603 | 2 170 | 67 | **33 840** | -140 | -614 | **33 086** |
| Credit cards | 172 | 0 | 0 | **172** | -4 | 0 | **168** |
| **Loans to individuals** | | | | | | | |
| Consumer loans | 31 120 | 0 | 3 354 | **34 474** | -1 169 | -86 | **33 219** |
| Hire-purchase | 50 101 | 6 772 | 454 | **57 327** | -824 | -30 | **56 473** |
| Leveraged loans | 2 621 | 0 | 0 | **2 621** | 0 | 0 | **2 621** |
| Leasing | 11 147 | 236 | 19 | **11 402** | -19 | -7 | **11 376** |
| Mortgage loans | 77 471 | 169 | 0 | **77 640** | -243 | 0 | **77 397** |
| Credit cards | 7 523 | 0 | 676 | **8 199** | -231 | -5 | **7 963** |
| Overdrafts | 77 | 1 | 3 | **81** | 0 | 0 | **81** |
| **Total** (Note 13) | **707 830** | **13 695** | **18 643** | **740 168** | **-5 071** | **-3 054** | **732 043** |

Overdue loan amounts include the total amount of the loans, not only the amount of overdue instalments.

There are several criteria for the loan to be considered individually impaired. Group's internal default definition is in line with the generally accepted criteria for definition of default: such as payment delay more than 90 days on any material credit obligation, distressed restructuring of the credit obligation, specific credit adjustment due to significant perceived decline in credit quality since inception, significant financial difficulties of the obligor or likely bankruptcy process, etc.

As part of risk analysis, the Group is regularly performing stress tests and sensitivity analysis regarding credit risk and its components (such as PD, LGD). Collective impairment credit assessment of the Group is based on historical loss rate and credit rating.

**Distribution of corporate loans and overdraft by internal ratings 31.12.2017**

| *(in thousands of euros)* | Neither past due nor impaired | Past due but not impaired | Individually impaired | Total |
|---|---|---|---|---|
| 4 low credit risk | 794 | 0 | 0 | 794 |
| 5 low credit risk | 18 637 | 0 | 0 | 18 637 |
| 6 low credit risk | 113 983 | 0 | 0 | 113 983 |
| 7 medium credit risk | 126 335 | 0 | 0 | 126 335 |
| 8 medium credit risk | 139 264 | 0 | 0 | 139 264 |
| 9 heightened credit risk | 44 452 | 0 | 0 | 44 452 |
| 10 high credit risk | 23 649 | 0 | 0 | 23 649 |
| 11 high credit risk | 6 898 | 3 716 | 0 | 10 613 |
| 12 non-satisfactory rating | 4 119 | 50 | 0 | 4 169 |
| 13 insolvent | 0 | 0 | 14 043 | 14 043 |
| **Total** | **478 131** | **3 766** | **14 043** | **495 940** |

Distribution of internal ratings for other loan products:

- Excellent – leveraged loans secured by debt or equity securities and loans with very low business risk.
- Very good – loans with lower business risks and no past due payments.
- Good – loans with lower business risks and past due payments up to 30 days.
- Satisfactory – loans with average business risk and up to 60 days past due.
- Weak or doubtful – loans carrying higher business risk, past due more than 60 days and portfolio in proceedings by the bailiff.

**As at 31.12.2017**
*(in thousands of euros)*

| | Retail loans | Leveraged loans | Credit cards | Leasing | Consumer loans | Hire-purchase | Over-draft | Mortgage loans | Total |
|---|---|---|---|---|---|---|---|---|---|
| **Neither past due nor impaired** | | | | | | | | | |
| Excellent | 0 | 7 168 | 0 | 0 | 0 | 0 | 0 | 0 | **7 168** |
| Good and very good | 13 049 | 0 | 7 695 | 42 750 | 31 120 | 50 369 | 77 | 77 471 | **222 531** |
| **Past due but not impaired** | | | | | | | | | |
| Good | 481 | 0 | 0 | 1 725 | 0 | 5 202 | 0 | 169 | **7 577** |
| Satisfactory | 61 | 0 | 0 | 664 | 0 | 1 266 | 1 | 0 | **1 992** |
| Weak or doubtful | 39 | 0 | 0 | 17 | 0 | 304 | 0 | 0 | **360** |
| Individually impaired | | | | | | | | | |
| Good | 0 | 0 | 78 | 0 | 2 160 | 52 | 0 | 0 | **2 290** |
| Satisfactory | 0 | 0 | 221 | 0 | 623 | 51 | 0 | 0 | **895** |
| Weak or doubtful | 26 | 0 | 377 | 86 | 571 | 352 | 3 | 0 | **1 415** |
| **Total** | **13 656** | **7 168** | **8 371** | **45 242** | **34 474** | **57 596** | **81** | **77 640** | **244 228** |

**Structure of past due but not impaired loans according to past due time** (loans, which have overdue interest or principal payments as at the end of the reporting period, are divided in past due categories according to the past due time from the earliest outstanding payment):

**As at 31.12.2017**
*(in thousands of euros)*

| | Corporate loans (incl. overdraft) | Retail loans | Leasing | Hire-purchase | Overdraft to private individuals | Mortgage loan | Total |
|---|---|---|---|---|---|---|---|
| **Past due receivables** | | | | | | | |
| 1-30 days | 56 | 481 | 1 725 | 5 202 | 0 | 169 | **7 633** |
| 31-60 days | 3 710 | 61 | 664 | 1 266 | 1 | 0 | **5 702** |
| 61-90 days | 0 | 39 | 17 | 304 | 0 | 0 | **360** |
| 91-180 days | 0 | 0 | 0 | 0 | 0 | 0 | **0** |
| 181-360 days | 0 | 0 | 0 | 0 | 0 | 0 | **0** |
| more than 360 days | 0 | 0 | 0 | 0 | 0 | 0 | **0** |
| **Total** | **3 766** | **581** | **2 406** | **6 772** | **1** | **169** | **13 695** |

**Structure of individually impaired loans according to past due time** (loans, which have overdue interest or principal payments as at the end of the reporting period, are divided in past due categories according to the past due time from the earliest outstanding payment):

**As at 31.12.2017**
*(in thousands of euros)*

| | Corporate loans (incl. overdraft) | Retail loans | Lever-aged loans | Credit cards | Leasing | Hire-purchase | Consumer loans | Overdraft to private individuals | Total |
|---|---|---|---|---|---|---|---|---|---|
| No payments over deadline | 0 | 0 | 0 | 0 | 0 | 12 | 37 | 0 | **49** |
| Past due receivables | | | | | | | | | |
| 1-30 days | 0 | 0 | 0 | 78 | 0 | 40 | 2 123 | 0 | **2 241** |
| 31-60 days | 0 | 0 | 0 | 221 | 0 | 51 | 623 | 0 | **895** |
| 61-90 days | 0 | 0 | 0 | 115 | 0 | 35 | 268 | 0 | **418** |
| 91-180 days | 12 664 | 26 | 0 | 176 | 78 | 161 | 159 | 3 | **13 267** |
| 181-360 days | 0 | 0 | 0 | 60 | 7 | 37 | 88 | 0 | **192** |
| More than 360 days | 1 379 | 0 | 0 | 26 | 1 | 119 | 56 | 0 | **1 581** |
| **Total** | **14 043** | **26** | **0** | **676** | **86** | **455** | **3 354** | **3** | **18 643** |

**Impact to impairment as at 31.12.2017**

(in case PD and LGD levels will increase by 10%)

*(in thousands of euros)*

| | Balance as at 31.12.2017 | Impairment with increased PDs and LGDs | Impact to impairment booked |
|---|---|---|---|
| **Loans to legal entities** | | | |
| Corporate loans (incl. overdraft) | 495 940 | -5 056 | -462 |
| Leasing | 33 840 | -783 | -29 |
| Retail loans | 13 656 | -188 | -33 |
| **Loans to individuals** | | | |
| Consumer loans | 34 474 | -1 509 | -254 |
| Hire-purchase | 57 327 | -1 015 | -161 |
| Mortgage loan | 77 640 | -294 | -51 |
| Leasing | 11 402 | -31 | -5 |
| Credit card loans | 8 199 | -277 | -41 |
| **Total** | **732 478** | **-9 153** | **-1 036** |

**3.2.4.3 Maximum exposure to credit risk – Financial instruments not subject to impairment**

Financial assets kept in fair value are by definition not subject to impairment, their changes in credit risk is automatically accounted through market value changes.

In addition some accounts carrying smaller credit risk are not part of impairment calculation:

- **Cash and balances with central bank**
- **Nostro accounts**

Both of these account types carry very limited amount of credit risk and maturity tenor is general is just 1 day. Cash and central bank balances are limited per currencies – only currencies bank is active are allowed. Nostro accounts are subject to credit risk limits, all counterparts have to minimally have investment grade rating. In case counterparts rating is lowered below investment grade, the nostro account will not qualify for having balances by the end of banking day.

**3.2.4.4 Collateral**

The Group employs a range of policies and practices to mitigate credit risk. The most common of these is accepting collateral for funds advanced. The Group has internal policies on the acceptability of specific classes of collateral or credit risk mitigation.

The Group prepares a valuation of the collateral obtained as part of the loan origination process. This assessment is reviewed periodically. The valuations of the market value of collaterals are based on the principle of conservatism, which takes into account the type of collateral, the location, the likelihood of realization and liquidity.

Expert evaluations are used to evaluate immovables. In order to ensure that market values are up to date, the individual assessments of commercial real estate are updated at least once a year. In the case of residential and other homogeneous types of real estate, statistical indexation models are also used for regular re-evaluation.

The principal collateral types for loans and advances are:

- Mortgage
- Guarantee of KredEx Fund or Rural Development Foundation
- Deposit
- Marketable securities
- Rights of claims
- Commercial pledge
- Pledge of shares
- Pledge of claim
- Surety of private person or legal entity
- Machinery and equipment

The preferred collateral is where there is no strong correlation between the client's default risk and value of the collateral. In general, the pledged assets need to be secured, the life of the collateral needs to be longer than the due date of the loan and the market value of the collateral needs to exceed the outstanding loan balance.

Unsecured loan can be issued to private customers up to a specified amount. For corporate customers this is only allowed when cash flow forecast shows stable and significantly strong cash flows and/or customer's credit risk is valued to be low.

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The Group's policies regarding obtaining collateral have not significantly changed during the reporting period and there has been no significant change in the overall quality of the collateral held by the Group since the prior period.

Mortgage business has sufficiently low 'loan to value' (LTV) ratios, which results in low loss allowance being recognised in accordance with the Group's expected credit loss model. The carrying amount of such financial assets is EUR 101 009 thousand as at 31 December 2018.

The Group closely monitors collateral held for financial assets considered to be credit-impaired, as it becomes more likely that the Group will take possession of collateral to mitigate potential credit losses. Financial assets that are credit-impaired and related collateral held in order to mitigate potential losses are shown below:

**31.12.2018**
*(in thousands of euros)*

| | Gross exposure | Impairment allowance | Carrying amount | Fair value of collateral held |
|---|---|---|---|---|
| **Credit-impaired assets** | | | | |
| Loans to corporate entities: | | | | |
| - Large corporate customers | 380 | (186) | 194 | 194 |
| **Total credit-impaired assets** | **380** | **(186)** | **194** | **194** |

In the table below, collateral information of loans and advances are disclosed based on the collateral type and carrying value or fair value of collateral held if it is lower.

The under-collateralised amount is presented as “Unsecured loans”.

**Loans against collateral as at 31.12.2018**
*(in thousands of euros)*

| | Corporate and retail loans (including overdraft) | Leveraged loans | Credit cards, consumer loans, overdraft to private individuals | Leasing | Hire-purchase | Mortgage loans | Total |
|---|---|---|---|---|---|---|---|
| Listed securities | 0 | 3 730 | 0 | 0 | 0 | 0 | 3 730 |
| Unlisted equity securities | 21 257 | 0 | 673 | 0 | 0 | 0 | 21 930 |
| Mortgages, real estate | 333 498 | 0 | 28 224 | 0 | 0 | 100 281 | 462 003 |
| Guarantee of KredEx and Rural Development Foundation | 4 395 | 0 | 0 | 0 | 0 | 0 | 4 395 |
| Pledges of rights of claim | 35 250 | 0 | 0 | 0 | 0 | 0 | 35 250 |
| Deposits | 3 168 | 0 | 1 654 | 0 | 0 | 0 | 4 822 |
| Leased assets | 53 309 | 0 | 0 | 41 033 | 0 | 0 | 94 342 |
| Others | 25 136 | 0 | 7 390 | 0 | 0 | 0 | 32 526 |
| Unsecured loans | 191 525 | 0 | 40 904 | 19 132 | 17 750 | 728 | 270 039 |
| **Total** | **667 538** | **3 730** | **78 845** | **60 165** | **17 750** | **101 009** | **929 037** |

**Loans against collateral as at 31.12.2017**
*(in thousands of euros)*

| | Corporate and retail loans (including overdraft) | Leveraged loans | Credit cards, consumer loans, overdraft to private individuals | Leasing | Hire-purchase | Mortgage loans | Total |
|---|---|---|---|---|---|---|---|
| Listed securities | 0 | 7 168 | 0 | 0 | 0 | 0 | 7 168 |
| Unlisted equity securities | 36 603 | 0 | 0 | 0 | 0 | 0 | 36 603 |
| Mortgages, real estate | 233 876 | 0 | 0 | 0 | 0 | 77 640 | 311 516 |
| Guarantee of KredEx and Rural Development Foundation | 4 410 | 0 | 0 | 0 | 0 | 0 | 4 410 |
| Pledges of rights of claim | 15 163 | 0 | 0 | 0 | 0 | 0 | 15 163 |
| Deposits | 3 262 | 0 | 0 | 0 | 0 | 0 | 3 262 |
| Leased assets | 0 | 0 | 0 | 45 242 | 57 596 | 0 | 102 838 |
| Others | 90 915 | 0 | 81 | 0 | 0 | 0 | 90 996 |
| Unsecured loans | 125 367 | 0 | 42 845 | 0 | 0 | 0 | 168 212 |
| **Total** | **509 596** | **7 168** | **42 926** | **45 242** | **57 596** | **77 640** | **740 168** |

Collaterals for leveraged loans are monitored on a daily basis and, if collateral value is falling, immediate measures are taken to avoid credit losses. As of 31 December 2018 and as of 31 December 2017, all leveraged loans are over-collateralized. Consumer loans and credit card loans are issued without collateral and risk mitigation is done by regular monitoring of clients payment behaviour. Leasing and mortgage loans are all over-collateralized. The Group monitors customers in arrears of leasing, hire purchase, mortgage loans and overdraft to private individuals on regular basis.

In relation to under-collateralized corporate loans, it should be taken into consideration, that the Group has assessed the market value of certain collaterals conservatively (personal sureties, commercial pledges). Under-collateralized loans are mainly considered to bear higher risk, for which the Group carries out monthly monitoring in credit committee, in order to mitigate potential credit losses. Under-collateralized loans include contracts with more than 90 days overdue totalling EUR 13 592 thousand (2017: EUR 1 383 thousand) euros with a collateral value of 7 172 thousand (2017: EUR 0 thousand) euros.

| *(in thousands of euros)* | **Over-collateralized loans** | | **Under-collateralized loans** | |
|---|---|---|---|---|
| | Carrying value | Fair value of collateral | Carrying value | Fair value of collateral |
| **As at 31.12.2018** | **364 598** | **616 532** | **564 439** | **294 379** |
| Corporate and retail loans (including overdraft) | 236 687 | 397 060 | 430 851 | 239 326 |
| Leveraged loans | 3 730 | 6 293 | 0 | 0 |
| Credit cards, consumer loans, overdraft to private individuals | 37 846 | 100 820 | 40 999 | 74 |
| Leasing | 0 | 0 | 60 165 | 41 033 |
| Hire-purchase | 0 | 0 | 17 750 | 0 |
| Mortgage loans | 86 335 | 112 359 | 14 674 | 13 946 |
| **As at 31.12.2017** | | | | |
| Corporate loans and overdraft | **208 356** | **552 362** | **301 002** | **175 873** |

### 3.2.5 Loss allowance

The loss allowance recognised in the period is impacted by a variety of factors, as described below:

- Transfers between Stage 1 and Stages 2 or 3 due to financial instruments experiencing significant increases (or decreases) of credit risk or becoming credit-impaired in the period, and the consequent „step up“ (or „step down“) between 12-month and Lifetime ECL;
- Additional allowances for new financial instruments recognised during the period, as well as releases for financial instruments de-recognised in the period;
- Impact on the measurement of ECL due to changes in PDs, EADs and LGDs in the period, arising from regular update of inputs to models;
- Impacts on the measurement of ECL due to changes made to models and assumptions;
- Discount unwind within ECL due to the passage of time, as ECL is measured on a present value basis;
- Foreign exchange retranslations for assets denominated in foreign currencies and other movements; and
- Financial assets derecognised during the period and write-offs of allowances related to assets that were written off during the period (see note 3.3.6.).

The following tables explain the changes in the loss allowances between the beginning and the end of the annual period due to these factors.

**Corporate loans and overdraft**

*(in thousands of euros)*

| | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Loss allowance as at 1 January 2018** | 1 112 | 1 241 | 2 199 | 0 | 4 552 |
| **Movements with P&L impact** | -226 | 226 | 0 | 0 | 0 |
| Transfers: | | | | | |
| From Stage 1 to Stage 2 | -227 | 227 | NA | 0 | 0 |
| From Stage 1 to Stage 3 | 0 | NA | 0 | 0 | 0 |
| From Stage 2 to Stage 1 | 1 | -1 | NA | 0 | 0 |
| New financial assets originated or purchased | 1 165 | 86 | 0 | 186 | 1 437 |
| Changes in PDs/LGDs/EADs | 192 | -455 | 3 091 | 0 | 2 828 |
| Changes to model assumptions and methodologies | 28 | 24 | 0 | 0 | 52 |
| Modifications of contractual cash flows of financial assets | 0 | 0 | 0 | 0 | 0 |
| Unwind of discount | 0 | 0 | 10 | 0 | 10 |
| FX and other movements | 0 | 0 | 0 | 0 | 0 |
| **Total net P&L charge during the period** | **1 159** | **-119** | **3 101** | **186** | **4 327** |
| | | | | | |
| **Other movements with no P&L impact** | | | | | |
| Transfers: | | | | | |
| From Stage 2 to Stage 3 | NA | 0 | 0 | 0 | 0 |
| From Stage 3 to Stage 2 | NA | 0 | 0 | 0 | 0 |
| Financial assets derecognised during the period | 0 | 0 | 0 | 0 | 0 |
| Write-offs | 0 | 0 | 115 | 0 | 115 |
| **Loss allowance as at 31 December 2018** | **2 271** | **1 122** | **5 299** | **186 284** | **8 879** |

**Retail loans to SMEs**

*(in thousands of euros)*

| | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Loss allowance as at 1 January 2018** | 131 | 0 | 0 | 0 | 131 |
| **Movements with P&L impact** | -148 | 49 | 99 | 0 | 0 |
| Transfers: | | | | | |
| From Stage 1 to Stage 2 | -49 | 49 | NA | 0 | 0 |
| From Stage 1 to Stage 3 | -99 | NA | 99 | 0 | 0 |
| From Stage 2 to Stage 1 | 0 | 0 | NA | 0 | 0 |
| New financial assets originated or purchased | 20 | 1 | 0 | 0 | 21 |
| Changes in PDs/LGDs/EADs | 46 | 3 | -1 | 0 | 48 |
| Changes to model assumptions and methodologies | 1 | 1 | 0 | 0 | 2 |
| Modifications of contractual cash flows of financial assets | 0 | 0 | 0 | 0 | 0 |
| Unwind of discount | 0 | 0 | 1 | 0 | 1 |
| FX and other movements | 0 | 0 | 0 | 0 | 0 |
| **Total net P&L charge during the period** | **-81** | **54** | **99** | **0** | **72** |
| | | | | | |
| **Other movements with no P&L impact** | | | | | |
| Transfers: | | | | | |
| From Stage 2 to Stage 3 | NA | 0 | 0 | 0 | 0 |
| From Stage 3 to Stage 2 | NA | 0 | 0 | 0 | 0 |
| Financial assets derecognised during the period | 0 | 0 | 0 | 0 | 0 |
| Write-offs | 0 | 0 | 25 | 0 | 25 |
| **Loss allowance as at 31 December 2018** | **50** | **54** | **99** | **0** | **203** |

**Consumer loans**

*(in thousands of euros)*

| | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Loss allowance as at 1 January 2018** | 442 | 0 | 0 | 0 | 442 |
| **Movements with P&L impact** | -219 | 133 | 86 | 0 | 0 |
| Transfers: | | | | | |
| From Stage 1 to Stage 2 | -133 | 133 | NA | 0 | 0 |
| From Stage 1 to Stage 3 | -86 | NA | 86 | 0 | 0 |
| From Stage 2 to Stage 1 | 0 | 0 | NA | 0 | 0 |
| New financial assets originated or purchased | 212 | 32 | 1 | 0 | 245 |
| Changes in PDs/LGDs/EADs | -223 | 102 | 2 | 0 | 119 |
| Changes to model assumptions and methodologies | 0 | 0 | 0 | 0 | 0 |
| Modifications of contractual cash flows of financial assets | 0 | 0 | 0 | 0 | 0 |
| Unwind of discount | 0 | 0 | 0 | 0 | 0 |
| FX and other movements | 0 | 0 | 0 | 0 | 0 |
| **Total net P&L charge during the period** | **-230** | **267** | **89** | **0** | **126** |
| **Other movements with no P&L impact** | | | | | |
| Transfers: | | | | | |
| From Stage 2 to Stage 3 | NA | 0 | 0 | 0 | 0 |
| From Stage 3 to Stage 2 | NA | 0 | 0 | 0 | 0 |
| Financial assets derecognised during the period | 0 | 0 | 0 | 0 | 0 |
| Write-offs | 0 | 0 | 0 | 0 | 0 |
| **Loss allowance as at 31 December 2018** | **212** | **267** | **89** | **0** | **568** |

**Hire-purchase**

*(in thousands of euros)*

| | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Loss allowance as at 1 January 2018** | 99 | 5 | 3 | 0 | 108 |
| **Movements with P&L impact** | -38 | 21 | 17 | 0 | 0 |
| Transfers: | | | | | |
| From Stage 1 to Stage 2 | -21 | 21 | NA | 0 | 0 |
| From Stage 1 to Stage 3 | -17 | NA | 17 | 0 | 0 |
| From Stage 2 to Stage 1 | 0 | 0 | NA | 0 | 0 |
| New financial assets originated or purchased | 70 | 8 | 11 | 0 | 89 |
| Changes in PDs/LGDs/EADs | -77 | 11 | 9 | 0 | -57 |
| Changes to model assumptions and methodologies | 0 | 0 | 0 | 0 | 0 |
| Modifications of contractual cash flows of financial assets | 0 | 0 | 0 | 0 | 0 |
| Unwind of discount | 0 | 0 | 0 | 0 | 0 |
| FX and other movements | 0 | 0 | 0 | 0 | 0 |
| **Total net P&L charge during the period** | **-44** | **40** | **36** | **0** | **32** |
| **Other movements with no P&L impact** | | | | | |
| Transfers: | | | | | |
| From Stage 2 to Stage 3 | NA | -8 | 8 | 0 | 0 |
| From Stage 3 to Stage 2 | NA | 0 | 0 | 0 | 0 |
| Financial assets derecognised during the period | 0 | 0 | 0 | 0 | 0 |
| Write-offs | 0 | 0 | 0 | 0 | 0 |
| **Loss allowance as at 31 December 2018** | **55** | **46** | **39** | **0** | **140** |

**Mortgage loans**

*(in thousands of euros)*

| | Stage 1 12-month ECL | Stage 2 Lifetime ECL | Stage 3 Lifetime ECL | Purchased Credit Impaired | Total |
|---|---|---|---|---|---|
| **Loss allowance as at 1 January 2018** | 32 | 0 | 0 | 0 | 32 |
| **Movements with P&L impact** | 0 | 0 | 0 | 0 | 0 |
| Transfers: | | | | | |
| From Stage 1 to Stage 2 | 0 | 0 | NA | 0 | 0 |
| From Stage 1 to Stage 3 | 0 | NA | 0 | 0 | 0 |
| From Stage 2 to Stage 1 | 0 | 0 | NA | 0 | 0 |
| New financial assets originated or purchased | 42 | 3 | 0 | 0 | 45 |
| Changes in PDs/LGDs/EADs | -58 | 5 | 0 | 0 | -53 |
| Changes to model assumptions and methodologies | 0 | 0 | 0 | 0 | 0 |
| Modifications of contractual cash flows of financial assets | 0 | 0 | 0 | 0 | 0 |
| Unwind of discount | 0 | 0 | 0 | 0 | 0 |
| FX and other movements | 0 | 0 | 0 | 0 | 0 |
| **Total net P&L charge during the period** | **-16** | **9** | **0** | **0** | **-7** |
| | | | | | |
| **Other movements with no P&L impact** | | | | | |
| Transfers: | | | | | |
| From Stage 2 to Stage 3 | NA | 0 | 0 | 0 | 0 |
| From Stage 3 to Stage 2 | NA | 0 | 0 | 0 | 0 |
| Financial assets derecognised during the period | 0 | 0 | 0 | 0 | 0 |
| Write-offs | 0 | 0 | 0 | 0 | 0 |
| **Loss allowance as at 31 December 2018** | **17** | **9** | **0** | **0** | **26** |

**Leasing**

*(in thousands of euros)*

| | Stage 1 12-month ECL | Stage 2 Lifetime ECL | Stage 3 Lifetime ECL | Purchased Credit Impaired | Total |
|---|---|---|---|---|---|
| **Loss allowance as at 1 January 2018** | 233 | 0 | 0 | 0 | 233 |
| **Movements with P&L impact** | -268 | 238 | 30 | 0 | 0 |
| Transfers: | | | | | |
| From Stage 1 to Stage 2 | -238 | 238 | NA | 0 | 0 |
| From Stage 1 to Stage 3 | -30 | NA | 30 | 0 | 0 |
| From Stage 2 to Stage 1 | 0 | 0 | NA | 0 | 0 |
| New financial assets originated or purchased | 43 | 7 | 0 | 0 | 50 |
| Changes in PDs/LGDs/EADs | 85 | 67 | 33 | 0 | 185 |
| Changes to model assumptions and methodologies | 0 | 0 | 0 | 0 | 0 |
| Modifications of contractual cash flows of financial assets | 0 | 0 | 0 | 0 | 0 |
| Unwind of discount | 0 | 0 | 0 | 0 | 0 |
| FX and other movements | 0 | 0 | 0 | 0 | 0 |
| **Total net P&L charge during the period** | **-140** | **312** | **63** | **0** | **235** |
| | | | | | |
| **Other movements with no P&L impact** | | | | | |
| Transfers: | | | | | |
| From Stage 2 to Stage 3 | NA | 0 | 0 | 0 | 0 |
| From Stage 3 to Stage 2 | NA | 0 | 0 | 0 | 0 |
| Financial assets derecognised during the period | 0 | 0 | 0 | 0 | 0 |
| Write-offs | 0 | 0 | 0 | 0 | 0 |
| **Loss allowance as at 31 December 2018** | **92** | **312** | **63** | **0** | **467** |

Significant changes in the gross carrying amount of financial assets that contributed to changes in the loss allowance were as follows:

- Changes in loss allowances of corporate loan portfolio explained in detail in table below

The following table further explains changes in the gross carrying amount of the portfolio to help explain their significance to the changes in the loss allowance for the same portfolio as discussed above:

**Corporate loans and overdrafts**

*(in thousands of euros)*

| | **Stage 1** 12-month ECL | **Stage 2** Lifetime ECL | **Stage 3** Lifetime ECL | Purchased Credit Impaired | **Total** |
|---|---|---|---|---|---|
| **Gross carrying amount as at 1 January 2018** | **456 747** | **25 150** | **14 043** | **0** | **495 940** |
| **Movements with P&L impact** | | | | | |
| Transfers: | | | | | |
| From Stage 1 to Stage 2 | -11 244 | 11 244 | NA | 0 | 0 |
| From Stage 1 to Stage 3 | 0 | NA | 0 | 0 | 0 |
| From Stage 2 to Stage 3 | NA | -3 415 | 3 415 | 0 | 0 |
| From Stage 3 to Stage 2 | NA | 0 | 0 | 0 | 0 |
| From Stage 2 to Stage 1 | 2 208 | -2 208 | NA | 0 | 0 |
| Financial assets derecognised during the period | 45 325 | 4 479 | 5 298 | 0 | 55 102 |
| New financial assets originated or purchased | 204 715 | 2 066 | 0 | 380 | 207 161 |
| Modifications of contractual cash flows of financial assets | 0 | 0 | 0 | 0 | 0 |
| Changes in interest accrual | 367 | 20 | 0 | 0 | 387 |
| Write-offs | 0 | 0 | 115 | 0 | 115 |
| FX and other movements | 0 | 0 | 0 | 0 | 0 |
| **Gross carrying amount as at 31 December 2018** | **607 468** | **28 378** | **12 045** | **380** | **648 271** |

The Group considers the loan as non-performing and assesses impairment when the loan payments have not been collected by the due date and/or the expected cash flows from the realization of collateral are not sufficient for covering the carrying amount of the loan principal and interest payments.

The Group evaluates these loans individually. In case of individual evaluation, the amount of the impairment loss is the difference between the carrying value of the receivable and expected cash flows discounted at the effective interest rate. In 2018, the Group provisioned corporate loans in the total amount of EUR 4 303 thousand (2017: EUR 2 267 thousand).

Loan customers with ratings of 10-13 are subject to more frequent monitoring during which the solvency of the borrower is evaluated. In case of a deterioration of payment behaviour, the requirement for individual provisioning is evaluated, considering, among other factors, the collateral of the loan, therefore some loans are not individually impaired, because they are sufficiently secured. The ratings-based rate of the collective provisioning is applied to those loans.

In addition to loans issued, loan agreements have been concluded and signed for the unused loan commitment amount of EUR 188 841 thousand at 31.12.2018 (31.12.2017: EUR 179 572 thousand).

In the following table there are presented unused portions of corporate loans and financial guarantee limits. In addition to that as at 31.12.2018 the Group has also committed to grant mortgage loans, hire-purchase loans, consumer loans, overdraft loans and credit card loans to individuals in total amount of EUR 41 430 thousand (31.12.2017: EUR 48 899 thousand). All uncommissioned loans available to individuals have at least investment grade scoring as at the end of each reporting period.

**Credit quality of off-balance sheet liabilities**

**(unused loan commitments for corporate loans and financial guarantees)**

*(in thousands of euros)*

| | **31.12.2018** | **31.12.2017** |
|---|---|---|
| 5 low credit risk | 5 302 | 5 632 |
| 6 low credit risk | 17 202 | 13 135 |
| 7 medium credit risk | 25 997 | 25 582 |
| 8 medium credit risk | 71 244 | 57 446 |
| 9 heightened credit risk | 25 142 | 28 932 |
| 10 high credit risk | 10 534 | 4 176 |
| 11 high credit risk | 17 | 342 |
| 12 payments are delayed | 604 | 0 |
| 13 payments are delayed | 0 | 760 |
| Non-rated (retail clients) | 737 | 719 |
| **Total** | **156 780** | **136 724** |

The total amount of undiscounted expected credit losses at initial recognition for purchased or originated credit-impaired financial assets recognised during the period was EUR 186 thousand.

### 3.2.6. Write-off policy

The Group writes off financial assets, in whole or in part, when it has exhausted all practical recovery efforts and has concluded that there is no reasonable expectation of recovery. The write-off represents a dercognition event.

Indicators that there is no reasonable expectation of recovery include (i) ceasing enforcement activity and (ii) where the Group's recovery method is foreclosing on collateral and the value of the collateral is such that there is no reasonable expectation of recovery.

If it is not feasible or economically reasonable for the Group to take measures to recover the claims that are being discounted, the claim is assessed as non-performing and is removed from the statement of financial position. If an irrecoverable claim is received subsequently, receipts are recognized as income.

At least one of the conditions has to be filled to declare claim irredeemable based on the product class.

Credit cards and hire purchase

There has been no significant contribution in 12 months since the client's insolvency (default) and the court proceedings relating to arrears have terminated to the Group's detriment or the client fails to comply with the court decision

A bankruptcy has been announced to the client or the client has been declared insolvent

The court confirms the debt restructuring plan (the claim recognized in the plan is less and the actual claim)

Criminal proceedings have been initiated in relation to issued credit or fraud has been used to obtain credit

The customer is dead and after the inventory of the estate bankruptcy is declared

The client forwarded to the bailiff has a foreign address or none at all.

Leasing, private and business loans

The client does not voluntarily reimburse the Group's claim risen from the difference of original claim and the realization of the collateral.

### 3.2.7. Modifications of financial assets

The Group sometimes modifies the terms of loans provided to customers due to commercial renegotiations, or for distressed loans, with a view to maximising recovery.

Such restructuring activities include extended payment term arrangements, payment holidays and payment forgiveness. Restructuring policies and practices are based on indicators or criteria which, in the judgement of management, indicate that payment will most likely continue. These policies are kept under continuous review. Restructuring is most commonly applied to term loans.

The risk of default of such assets after modification is assessed at the reporting date and compared with the risk under the original terms at initial recognition, when the modification is not substantial and so does not result in derecognition of the original asset (refer to note 2.6). The Group monitors the subsequent performance of modified assets. The Group may determine that the credit risk has significantly improved after restructuring, so that the assets are moved from Stage 3 or Stage 2 (Lifetime ECL) to Stage 1 (12-month ECL). This is only the case for assets which have performed in accordance with the new terms for six consecutive months or more. The gross carrying amount of such assets held as at 31 December 2018 was EUR 0 thousand.

The Group continues to monitor if there is a subsequent significant increase in credit risk in relation to such assets through the use of specific models for modified assets.

There were no such financial assets with lifetime ECL whose cash flows were modified during the period.

## 3.3 Market risk

Market risk arises from the Group's trading and investment activities in the financial markets from interest rate products, foreign exchange and stock markets as well as lending activities and collecting financial resources. Market risk is a potential loss, which may arise from unfavourable changes in foreign exchange rates, prices of securities or interest rates. Internal judgement is used to assess potential losses. In order to mitigate market risk, conservative limits have been established for the trading portfolio and open foreign currency exposures.

LHV Varahaldus invests most of its available resources into his own managed pension funds. The management of LHV Varahaldus is responsible for monitoring of the market risk.

### 3.3.1 Foreign currency risk

Foreign currency risk may arise from acquisition of securities mostly denominated in foreign currencies or foreign currency receivables and liabilities. The Treasury of the Bank is responsible for daily monitoring of open foreign currency positions. The Group's foreign currency risk management is based on market +risk policies, limits and internal procedures. The internal limits for open foreign currency positions are proposed by Risk Control unit and Treasury and the limits are set internally by Risk and Capital Committee. The limits set by the Committee are maximum nominal limits in euro equivalent with a respect to the Group's net own funds. Limits imposed on individual currencies are in line with the boundaries proposed by the Bank of Estonia. If the open currency position exceeds the limits set by the Committee, measures are immediately implemented to close or reduce such positions (hedging the risk with relevant instruments, such as foreign currency forwards or futures).

A sensitivity analysis has been performed for the effect of possible reasonable changes attributable to open currency positions on statement of profit or loss, with the assumption of other conditions remaining constant.

**Impact on statement of profit or loss**
*(in thousands of euros)*

| | 2018 | 2017 |
|---|---|---|
| USD exchange rate +/- 10% | +/-13 | +/-16 |
| SEK exchange rate +/- 10% | +/-0 | +/-4 |
| GBP exchange rate +/- 10% | +/-10 | +/-1 |
| CHF exchange rate +/- 10% | +/-2 | +/-1 |

**Open currency exposures**

The following tables present the risks arising from open currency exposures. Assets and liabilities denominated in foreign currencies have been presented in euro equivalent in respective columns, according to the exchange rate prevailing at the end of the reporting period. Derivatives reported at fair value in the statement of financial position have been included at contractual amounts under off-balance sheet assets and liabilities. Open currency exposure and the volume of financial assets and liabilities of the Group at the end of the reporting period do not significantly differ from the average exposure during the year. The balances of total assets and total liabilities bearing currency risk do not include currency futures at their fair value, but they are shown here at their full contractual cash flow amounts as off-balance sheet assets and liabilities; also, the table does not include the assets (tangible and intangible assets) and liabilities (provisions) not bearing currency risk and equity

**31.12.2018**

*(in thousands of euros)*

| | Note | EUR | CHF | GBP | SEK | USD | Other | Total |
|---|---|---|---|---|---|---|---|---|
| **Assets bearing currency risk** | | | | | | | | |
| Due from banks and investment companies | 10 | 651 175 | 2 224 | 18 319 | 2 536 | 1 430 | 6 973 | 682 658 |
| Investments in debt and equity securities | 11b, 12 | 22 750 | 0 | 1 174 | 1 | 23 230 | 0 | 47 154 |
| Loans and advances to customers | 13 | 902 843 | 0 | 14 707 | 220 | 957 | 34 | 918 761 |
| Receivables from customers | 14 | 2 802 | 0 | 374 | 42 | 0 | 503 | 3 721 |
| Other financial assets | 15 | 840 | 0 | 0 | 0 | 2 096 | 0 | 2 936 |
| **Total assets bearing currency risk** | | **1 580 410** | **2 224** | **34 574** | **2 799** | **27 713** | **7 511** | **1 655 230** |
| **Liabilities bearing currency risk** | | | | | | | | |
| Deposits from customers and loans received | 17 | 1 356 671 | 2 194 | 41 600 | 6 363 | 29 297 | 7 657 | 1 443 782 |
| Financial liabilities at fair value | 12 | 0 | 0 | 0 | 0 | 3 | 8 | 11 |
| Accounts payable and other financial liabilities | 18 | 15 299 | 50 | 2 238 | 410 | 120 | 3 311 | 21 428 |
| Subordinated debt | 20 | 50 900 | 0 | 0 | 0 | 0 | 0 | 50 900 |
| **Total liabilities bearing currency risk** | | **1 422 870** | **2 244** | **43 838** | **6 773** | **29 420** | **10 976** | **1 516 121** |
| Open gross position derivative assets at contractual value | | 610 | 0 | 9 166 | 3 973 | 2 186 | 3 234 | 19 169 |
| Open gross position derivative liabilities at contractual value | | 18 559 | 0 | 0 | 0 | 610 | 0 | 19 169 |
| **Open foreign currency position** | | **139 591** | **-20** | **-98** | **-2** | **-130** | **-232** | **139 108** |

**31.12.2017**

*(in thousands of euros)*

| | Note | EUR | CHF | GBP | SEK | USD | Other | Total |
|---|---|---|---|---|---|---|---|---|
| **Assets bearing currency risk** | | | | | | | | |
| Due from banks and investment companies | 10 | 922 431 | 2 587 | 28 237 | 892 | 1 359 | 5 706 | 961 212 |
| Financial assets at fair value | 11, 12 | 21 998 | 0 | 0 | 4 | 34 603 | 29 | 56 634 |
| Loans and advances to customers | 13 | 730 165 | 0 | 4 | 14 | 1 832 | 28 | 732 043 |
| Receivables from customers | 14 | 9 357 | 7 | 204 | 11 | 145 | 76 | 9 800 |
| Other financial assets | 15 | 288 | 0 | 0 | 0 | 2 001 | 0 | 2 289 |
| **Total assets bearing currency risk** | | **1 684 239** | **2 594** | **28 445** | **921** | **39 940** | **5 839** | **1 761 978** |
| **Liabilities bearing currency risk** | | | | | | | | |
| Deposits from customers and loans received | 17 | 1 457 593 | 2 534 | 33 134 | 3 558 | 42 646 | 3 464 | 1 542 929 |
| Financial liabilities at fair value | 12 | 0 | 0 | 0 | 1 | 1 | 0 | 2 |
| Accounts payable and other financial liabilities | 18 | 63 596 | 66 | 259 | 82 | 54 | 2 775 | 66 832 |
| Subordinated debt | 20 | 30 900 | 0 | 0 | 0 | 0 | 0 | 30 900 |
| **Total liabilities bearing currency risk** | | **1 552 089** | **2 600** | **33 393** | **3 641** | **42 701** | **6 239** | **1 640 663** |
| Open gross position derivative assets at contractual value | | 699 | 0 | 4 959 | 2 763 | 3 615 | 450 | 12 486 |
| Open gross position derivative liabilities at contractual value | | 11 787 | 0 | 0 | 0 | 699 | 0 | 12 486 |
| **Open foreign currency position** | | **121 062** | **-7** | **10** | **43** | **155** | **51** | **121 315** |

### 3.3.2 Price risk

Financial instruments bearing price risk at Group are securities held in the trading portfolio and investment portfolio (Note 11, 12). At the Group, limits are set for the size of the trading portfolio and acceptable credit quality ratings are specified for debt securities in the investment portfolio. The risk management unit monitors the compliance with limits.

Pursuant to the Investment Funds Act, the minimum shares of LHV Varahaldus as the management company is 0.5% (according to the Investment Funds Act in force until 9 January 2017, it was 1%) of the number of units in each of the mandatory pension fund managed by it. Based on historical performance and volatility of the pension fund unit NAV changes, the price changes should remain +/- 10% in the next 12-month period with the most likely change +/-5% and the impact to statement of profit or loss is presented in the next table.

LHV Varahaldus invests the remaining available assets in euros, to ensure liquidity and to not bear investment risk.

Bank does not hold significant amounts of equity securities in its position (see Note 12), due to which the sensitivity to change in the market value of these positions is marginal.

Bank's debt securities portfolio recognised at the market price is short-term and of high quality, therefore, the effect of the changes in market risk premiums on the market value of the debt security portfolio should remain at around 1.0% (2017: 1.0%).

Sensitivity analysis of the impact to net result from the risk exposures of the Group's largest entity AS LHV Pank against reasonable possible change (in thousands euros):

**Impact on statement of profit or loss**

| *(in thousands of euros)* | 2018 | 2017 |
|---|---|---|
| Equity securities and fund units +/-10% | +/-51 | +/-43 |
| Mandatory pension fund units +/-5% | +/-380 | +/-313 |
| Debt securities (FVTPL) +/-1.0% (+/-1.0%) | +/-387 | +/-491 |

**Impact on other comprehensive income**

| *(in thousands of euros)* | 2018 | 2017 |
|---|---|---|
| Debt securities (AFS) +/-1.0% (+/-1.0%) | +/-0 | +/-6 |
| Equity securities (FVOCI/AFS) +/-10% | +/- 30 | +/- 22 |

### 3.3.3 Interest rate risk

Interest rate risk reflects the mismatch in the statement of financial position items and the off-balance sheet items when interest rate repricing periods, volumes or the underlying interest rate of assets, liabilities and derivatives do not correspond exactly. Group's interest rate risk management is based on risk policies, limits and internal procedures resulting in identification of all significant sources of interest rate risk and balanced risk taking. Interest rate risk is measured through various scenario analyses by calculating several net interest income scenarios and comparing the difference between these scenarios. The basic measures of interest rate risk uses two scenarios – an increase and a decrease of interest rates to measure the effect on the Group's net interest income for a 12-month period. Internal limits for interest rate risk management are set by AS LHV Pank's Risk and Capital Committee and the operational risk management is the Treasury's responsibility.

The goal of monitoring, measuring and managing interest rate risk is to evaluate the profitability of the Group's interest-bearing products, to forecast interest income and to set limits for risk management in order to prevent significant reduction of income through limitation of risks in three aspects:

- cash flow interest rate risk whereby in case of a 1% change in market interest rates, a change in annual net interest income is limited as compared to the estimated actual;
- sensitivity of interest income based on the duration of positions in the statement of financial position;
- fair value interest rate risk whereby in case of a 1% change in market interest rates, a change in the Group's economic value is limited (fair value of assets and liabilities is determined by discounting the future cash flows at the market rate of interest).

The statement of financial position and margins on assets and deposits are assumed to be constant over time. The deposits interest rates did not change in 2018 remaining at the level of up to 1.0% (up to 1.0% in 2017).

The interest rates for leveraged loans granted are changed at most once a month according to fluctuations in market interest rates. In 2018, the interest rate on loans received for specific purposes was around 1.0% (2017: 1.0%). The effective interest rate of subordinated debts entered into in 2014 was 7.44% and the effective interest rate of subordinated debts entered into in 2015 was 6.5%, the effective interest rate of subordinated debts entered into in 2018 was 6.0%. The information about subordinated debt contractual interest rates is provided in Note 21.

As at 31.12.2018, stress tests were performed to the biggest interest sensitive subsidiary of the group: AS LHV Pank. An increase of 1 percentage point in interest rates would affect the Bank's annual net interest income and profit by EUR +10 263 thousand (2017: EUR +5 584 thousand). In the same time, a decrease of 1 percentage point in interest rates would affect the Bank's annual net interest income (profit) by EUR -1 657 thousand (2017: EUR -1 567 thousand). A 1 percentage point increase in market interest rates would raise the Bank's economic value, i.e. equity, by EUR +11 437 thousand (2017: EUR+7 520 thousand). A 1 percentage point decrease in market interest rates would affect the Bank's economic value (equity) by EUR +25 265 thousand (2017: EUR +16 639 thousand). Effect on the Group's economic value is positive since the Group has invested in short-term assets, the loans granted to customers are largely based on the 6-month Euribor, the level of which does not fall below 0% according to loan agreements, and due to the longer-term nature of the demand obligations, the average duration of interest-bearing assets is shorter than the average duration of interest-bearing liabilities.

When calculating the effects of the change in the net interest income on profit and the simulation of the change in the economic capital, in the case of a decline in interest rates, the terms of loan contracts are taken into account and the assumption is made, that the interest rates of the deposits involved will not become negative. When simulating the increase in interest rates, the bank has followed the principles of conservatism – despite the fact that the market levels of derivative transactions give rise to a presumption, that in the next two years the market interest rates on term deposits will not drastically change, which could result in a significant amount of cash being transferred from demand deposits to term deposits – we have presumed, that the ratio of demand deposits to term deposits becomes equal.

Demand deposits have a duration of 2 years due to their behavioural nature.

The interest rate of demand deposits is not sensitive to market rate fluctuations.

The table below shows the structure of the interest-bearing assets and interest-bearing liabilities of LHV Group grouped by the recalculation dates of interest rates at the principal amounts of receivables and liabilities. Leveraged loans are treated as a one-month product maturing at the next interest fixing date.

| **31.12.2018** *(in thousands of euros)* | Note | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | Subtotal | Accrued interest | Impairments | Total |
|---|---|---|---|---|---|---|---|---|---|
| **Financial assets** | | | | | | | | | |
| Due from banks and investment companies | 10 | 682 658 | 0 | 0 | 0 | **682 658** | 0 | 0 | **682 658** |
| Financial assets at fair value (debt securities) | 11, 12 | 20 546 | 0 | 15 031 | 2 000 | **37 577** | 1 120 | 0 | **38 697** |
| Loans and advances to customers | 13 | 391 815 | 486 576 | 45 087 | 16 770 | **940 248** | 2 667 | -11 501 | **931 414** |
| **Total** | | **1 095 019** | **486 576** | **60 118** | **18 770** | **1 660 483** | **3 787** | **-11 501** | **1 652 769** |
| | | | | | | | | | |
| **Financial liabilities** | | | | | | | | | |
| Deposits from customers and loans received | 17 | 110 719 | 111 503 | 1 221 205 | 18 | **1 443 445** | 337 | 0 | **1 443 782** |
| Subordinated debt * | 20 | 0 | 0 | 0 | 50 900 | **50 900** | 314 | 0 | **51 214** |
| **Total** | | **110 719** | **111 503** | **1 221 205** | **50 918** | **1 494 345** | **651** | **0** | **1 494 996** |
| **Net interest sensitivity gap** | | **984 300** | **375 073** | **-1 161 087** | **-32 148** | **166 138** | | | |

| **31.12.2017** *(in thousands of euros)* | Note | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | Subtotal | Accrued interest | Impair-ments | Total |
|---|---|---|---|---|---|---|---|---|---|
| **Financial assets** | | | | | | | | | |
| Due from banks and investment companies | 10 | 961 212 | 0 | 0 | 0 | **961 212** | 0 | 0 | **961 212** |
| Financial assets at fair value (debt securities) | 11, 12 | 0 | 29 715 | 15 834 | 2 000 | **47 549** | 2 144 | 0 | **49 693** |
| Loans and advances to customers | 13 | 299 246 | 382 016 | 41 528 | 14 851 | **737 641** | 2 527 | -8 125 | **732 043** |
| **Total** | | **1 260 458** | **411 731** | **57 362** | **16 851** | **1 746 402** | **4 671** | **-8 125** | **1 742 948** |
| | | | | | | | | | |
| **Financial liabilities** | | | | | | | | | |
| Deposits from customers and loans received | 17 | 553 360 | 96 246 | 893 085 | 0 | **1 542 691** | 238 | 0 | **1 542 929** |
| Subordinated debt * | 20 | 0 | 0 | 0 | 30 900 | **30 900** | 210 | 0 | **31 110** |
| **Total** | | **553 360** | **96 246** | **893 085** | **30 900** | **1 573 591** | **448** | **0** | **1 574 039** |
| **Net interest sensitivity gap** | | **707 098** | **315 485** | **-835 723** | **-14 049** | **172 811** | | | |

* The contractual term of subordinated debts received in 2018 is 10 years and the interest rate is fixed at 6.0%. The contractual term of subordinated debts received in 2015 is 10 years and the interest rate is fixed at 6.5%. The contractual term of subordinated debts received in 2014 is 10 years and the interest rate is fixed at 7.25%.

## 3.4 Liquidity risk

Liquidity risk relates to the solvency of the Group to meet its contractual obligations on time and it arises from differences between maturities of assets and liabilities. The Group's liquidity management and strategy is based on risk policies, resulting in various liquidity risk measures, limits and internal procedures. As per policy statements, the Group's liquidity management reflects a conservative approach towards liquidity risk. The liquidity risk management includes stress testing and business continuity plan for liquidity management. Stress testing framework includes a survival period metrics, which represents a combined liquidity risk scenario, including both idiosyncratic and market-wide stress. Internal metrics are complemented by the Basel III metrics - the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) which the Group is fully compliant with as of 31.12.2018 and 31.12.2017. The aim of the LCR standard is to ensure that the Group has an adequate amount of unencumbered assets of high quality and liquidity that could be monetised without incurring material losses to meet a liquidity requirement in a 30-day stress scenario. The output of the standard is the ratio of liquid assets to stress scenario liquidity requirement, which has a limit of 100%. The Group's liquidity coverage ratio level as at 31.12.2018 was 148.5% (31.12.2017: 121%).

The objective of the NSFR is to ensure that the Group has adequate stable funding sources to finance longer-term assets. According to the proposals published in the banking regulation and the banking committee of Basel in October 2014, the Group's NSFR level as at 31.12.2018 was 148% (31.12.2017: 141%). The net stable funding ratio will be imposed as 100% minimum requirement from the year 2018.

The Treasury of the Bank is responsible for the management of liquidity risk. In order to hedge liquidity risk, the probable net position of receivables and liabilities by maturities is regularly monitored and adequate amounts of liquid assets are kept in each time period, also the concentration of the Group's liabilities by maturities is monitored. To enable covering unexpected monetary outflows, the Group holds a liquidity buffer. The liquidity buffer consists of cash and deposits with the central bank and liquid securities held by the Treasury, which can be readily sold or used as a collateral in funding operations with the central bank. The Group has a sufficient supply of liquid resources to enable issuing standby loans. As at 31.12.2018 and 31.12.2017, the Group does not have any debts past due.

Short-term loans can be obtained from the central bank, secured by the majority of instruments from the debt securities portfolio.

The following tables present the distribution of financial assets and liabilities, excl. derivatives, by due dates and by future contractual undiscounted cash flows and in a separate column the statement of financial position balance is disclosed. In the maturity analysis, the cash flows are split into the maturity buckets in which the cash flows occur (including interest cash flows). Explanation of the fair value of these financial assets and liabilities is presented in Note 3.6.

**31.12.2018**

| *(in thousands of euros)* | Note | On demand | Up to 3 months | 3-12 Months | 1-5 Years | Over 5 years | Carrying amount | Total |
|---|---|---|---|---|---|---|---|---|
| **Liabilities by contractual maturity dates** | | | | | | | | |
| Deposits from customers and loans received | 17 | 1 304 239 | 24 949 | 94 113 | 16 780 | 4 390 | **1 444 471** | **1 443 782** |
| Subordinated debt | 20 | 0 | 832 | 2 496 | 13 311 | 59 426 | **76 065** | **50 900** |
| Accounts payable and other financial liabilities | 18 | 0 | 21 428 | 0 | 0 | 0 | **21 428** | **21 428** |
| Unused loan commitments | 23 | 32 259 | 156 582 | 0 | 0 | 0 | **188 841** | **0** |
| Financial guarantees by contractual amounts | 23 | 0 | 9 314 | 0 | 0 | 0 | **9 314** | **0** |
| Foreign exchange derivatives (gross settled) | | 0 | 18 559 | 0 | 610 | 0 | **19 169** | **0** |
| Financial liabilities at fair value | 12 | 0 | 11 | 0 | 0 | 0 | **11** | **11** |
| **Total liabilities** | | **1 336 498** | **231 675** | **96 609** | **30 701** | **63 816** | **1 759 299** | **1 516 121** |
| **Assets held for managing liquidity risk by contractual maturity dates** | | | | | | | | |
| Due from banks and investment companies | 10 | 682 658 | 0 | 0 | 0 | 0 | **682 658** | **682 658** |
| Financial assets at fair value (debt securities) | 11, 12 | 0 | 20 690 | 0 | 15 845 | 2 161 | **38 696** | **38 697** |
| Loans and advances to customers | 13 | 0 | 63 584 | 198 293 | 634 077 | 154 853 | **1 050 807** | **918 761** |
| Receivables from customers | 14 | 0 | 3 721 | 0 | 0 | 0 | **3 721** | **3 721** |
| Other financial assets | 15 | 2 936 | 0 | 0 | 0 | 0 | **2 936** | **2 936** |
| Foreign exchange derivatives (gross settled) | | 0 | 18 559 | 0 | 610 | 0 | **19 169** | **0** |
| **Total assets held for managing liquidity risk** | | **685 594** | **106 554** | **198 293** | **650 532** | **157 014** | **1 797 987** | **1 646 773** |
| **Maturity gap from assets and liabilities** | | **-650 904** | **-125 121** | **101 684** | **619 831** | **93 198** | **38 688** | |

**31.12.2017**

| *(in thousands of euros)* | Note | On demand | Up to 3 months | 3-12 Months | 1-5 Years | Over 5 years | Carrying amount | Total |
|---|---|---|---|---|---|---|---|---|
| **Liabilities by contractual maturity dates** | | | | | | | | |
| Deposits from customers and loans received | 17 | 1 409 662 | 37 104 | 90 332 | 3 335 | 2 864 | 1 543 297 | 1 542 929 |
| Subordinated debt | 20 | 0 | 532 | 1 596 | 8 511 | 35 554 | 46 193 | 30 900 |
| Accounts payable and other financial liabilities | 18 | 0 | 66 832 | 0 | 0 | 0 | 66 832 | 66 832 |
| Unused loan commitments | 23 | 29 815 | 149 757 | 0 | 0 | 0 | 179 572 | 0 |
| Financial guarantees by contractual amounts | 23 | 0 | 5 999 | 0 | 0 | 0 | 5 999 | 0 |
| Foreign exchange derivatives (gross settled) | | 0 | 11 825 | 0 | 661 | 0 | 12 486 | 0 |
| Financial liabilities at fair value | 12 | 0 | 2 | 0 | 0 | 0 | 2 | 2 |
| **Total liabilities** | | **1 439 477** | **272 051** | **91 928** | **12 507** | **38 418** | **1 854 381** | **1 640 663** |
| **Assets held for managing liquidity risk by contractual maturity dates** | | | | | | | | |
| Due from banks and investment companies | 10 | 961 212 | 0 | 0 | 0 | 0 | 961 212 | 961 212 |
| Financial assets at fair value (debt securities) | 11, 12 | 0 | 180 | 30 952 | 17 005 | 2 084 | 50 221 | 49 693 |
| Loans and advances to customers | 13 | 0 | 55 668 | 171 720 | 488 968 | 95 517 | 811 873 | 732 043 |
| Receivables from customers | 14 | 0 | 9 800 | 0 | 0 | 0 | 9 800 | 9 800 |
| Other financial assets | 15 | 2 289 | 0 | 0 | 0 | 0 | 2 289 | 2 289 |
| Foreign exchange derivatives (gross settled) | | | 11 825 | 0 | 661 | 0 | 12 486 | 0 |
| **Total assets held for managing liquidity risk** | | **963 501** | **77 473** | **202 672** | **506 634** | **97 601** | **1 847 881** | **1 755 037** |
| **Maturity gap from assets and liabilities** | | **-475 976** | **-194 578** | **110 744** | **494 127** | **59 183** | **-6 500** | |

The following table presents the distribution of assets and liabilities by classification of current and non-current.

| *(in thousands of euros)* | Note | 31.12.2018 | 31.12.2017 |
|---|---|---|---|
| **Current assets** | | | |
| Due from central bank | 10 | 639 862 | 905 339 |
| Due from credit institutions | 10 | 25 791 | 40 498 |
| Due from investment companies | 10 | 17 005 | 15 375 |
| Available-for-sale financial assets | 11a | 0 | 555 |
| Financial assets at fair value through profit or loss | 12 | 20 392 | 30 427 |
| Loans and advances to customers | 13 | 225 036 | 239 615 |
| Receivables from customers | 14 | 3 721 | 9 800 |
| Other assets | 15 | 1 651 | 1 516 |
| **Total current assets** | | **933 458** | **1 243 125** |
| | | | |
| **Non-current assets** | | | |
| Available-for-sale financial assets | 11a | 0 | 220 |
| Equity instruments at FVOCI | 11b | 298 | 0 |
| Financial assets at fair value through profit or loss | 12 | 26 464 | 25 432 |
| Loans and advances to customers | 13 | 693 725 | 492 428 |
| Other financial assets | 15 | 2 936 | 2 289 |
| Tangible assets | 16 | 1 135 | 1 421 |
| Intangible assets | 16 | 15 470 | 4 327 |
| Goodwill | 6 | 3 614 | 3 614 |
| **Total non-current assets** | | **743 642** | **529 731** |
| **Total assets** | **5** | **1 677 100** | **1 772 856** |
| | | | |
| **Liabilities** | | | |
| **Current liabilities** | | | |
| Deposits from customers and loans received | 17 | 1 422 988 | 1 536 883 |
| Financial liabilities at fair value through profit or loss | 12 | 11 | 2 |
| Accounts payable and other liabilities | 18 | 24 644 | 71 070 |
| **Total current liabilities** | | **1 447 643** | **1 607 955** |
| | | | |
| **Non-current liabilities** | | | |
| Deposits from customers and loans received | 17 | 20 794 | 6 046 |
| Subordinated debt | 20 | 50 900 | 30 900 |
| **Total non-current liabilities** | | **71 694** | **36 946** |
| **Total liabilities** | **5** | **1 519 337** | **1 644 901** |

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## 3.5 Fair value of financial assets and financial liabilities

**31.12.2018**

| *(in thousands of euros)* | Note | Level 1 | Level 2 | Level 3 | Total fair value | Carrying value | Difference |
|---|---|---|---|---|---|---|---|
| **Financial assets at fair value through profit or loss** | | | | | | | |
| Shares and fund units* | 12 | 510 | 7 590 | 0 | **8 100** | **8 100** | **0** |
| Equity instruments at fair value through other comprehensive income | 11b | 0 | 0 | 298 | **298** | **298** | **0** |
| Debt securities at fair value through profit or loss | 12 | 38 697 | 0 | 0 | **38 697** | **38 697** | **0** |
| Interest rate swaps and foreign exchange forwards | 12 | 0 | 59 | 0 | **59** | **59** | **0** |
| **Total financial assets at fair value throught profit or loss** | | **39 207** | **7 649** | **298** | **47 154** | **47 154** | **0** |
| **Financial liabilities at fair value through profit or loss** | | | | | | | |
| Interest rate swaps and foreign exchange forwards | 12 | 0 | 11 | 0 | **11** | **11** | **0** |
| **Total financial liabilities at fair value throught profit or loss** | | **0** | **11** | **0** | **11** | **11** | **0** |
| **Financial assets at amortised cost** | | | | | | | |
| Due from other banks | 10 | 639 862 | 0 | 0 | **639 862** | **639 862** | **0** |
| Due from credit institutions | 10 | 25 791 | 0 | 0 | **25 791** | **25 791** | **0** |
| Due from investment companies | 10 | 17 005 | 0 | 0 | **17 005** | **17 005** | **0** |
| Loans and advances to customers | 13 | 0 | 0 | 924 825 | **924 825** | **918 761** | **6 064** |
| Receivables from customers | 14 | 3 721 | 0 | 0 | **3 721** | **3 721** | **0** |
| Other financial assets | 15 | 2 936 | 0 | 0 | **2 936** | **2 936** | **0** |
| **Total financial assets at amortised cost** | | **689 315** | **0** | **924 825** | **1 614 140** | **1 608 076** | **6 064** |
| **Financial liabilities at amortised cost** | | | | | | | |
| Deposits from customers and loans received | 17 | 0 | 0 | 1 443 926 | **1 443 926** | **1 443 782** | **144** |
| Subordinated debt | 20 | 0 | 0 | 51 475 | **51 475** | **51 214** | **261** |
| Accounts payable and other liabilities | 18 | 21 428 | 0 | 0 | **21 428** | **21 428** | **0** |
| **Total financial liabilities at amortised cost** | | **21 428** | **0** | **1 495 401** | **1 516 829** | **1 516 424** | **405** |

Total net gain recognised in OCI for level 3 financial assets amounted to EUR 42 thousand.

**31.12.2017**

| *(in thousands of euros)* | Note | Level 1 | Level 2 | Level 3 | Total fair value | Carrying value | Difference |
|---|---|---|---|---|---|---|---|
| **Financial assets at fair value through profit or loss** | | | | | | | |
| Shares and fund units* | 12 | 430 | 6 261 | 0 | **6 691** | **6 691** | **0** |
| Available-for-sale debt securities | 11 | 555 | 0 | 220 | **775** | **775** | **0** |
| Debt securities at fair value through profit or loss | 12 | 49 138 | 0 | 0 | **49 138** | **49 138** | **0** |
| Interest rate swaps and foreign exchange forwards | 12 | 0 | 30 | 0 | **30** | **30** | **0** |
| **Total financial assets at fair value through profit or loss** | | **50 123** | **6 291** | **220** | **56 634** | **56 634** | **0** |
| | | | | | | | |
| **Financial liabilities at fair value through profit or loss** | | | | | | | |
| Interest rate swaps and foreign exchange forwards | 12 | 0 | 2 | 0 | **2** | **2** | **0** |
| **Total financial liabilities at fair value through profit or loss** | | **0** | **2** | **0** | **2** | **2** | **0** |
| | | | | | | | |
| **Financial assets at amortised cost** | | | | | | | |
| Due from other banks | 10 | 920 714 | 0 | 0 | **920 714** | **920 714** | **0** |
| Due from credit institutions | 10 | 26 3120 | 0 | 0 | **26 312** | **26 312** | **0** |
| Due from investment companies | 10 | 14 186 | 0 | 0 | **14 186** | **14 186** | **0** |
| Loans and advances to customers | 13 | 0 | 0 | 741 340 | **741 340** | **732 043** | **9 297** |
| Receivables from customers | 14 | 9 924 | 0 | 0 | **9 800** | **9 800** | **0** |
| Other financial assets | 15 | 2 289 | 0 | 0 | **2 289** | **2 289** | **0** |
| **Total financial assets at amortised cost** | | **973 425** | **0** | **741 340** | **1 714 641** | **1 705 344** | **9 297** |
| | | | | | | | |
| **Financial liabilities at amortised cost** | | | | | | | |
| Deposits from customers and loans received | 17 | 0 | 0 | 1 543 083 | **1 543 083** | **1 542 929** | **154** |
| Subordinated debt | 20 | 0 | 0 | 31 994 | **31 994** | **31 110** | **884** |
| Accounts payable and other liabilities | 18 | 66 832 | 0 | 0 | **66 832** | **66 832** | **0** |
| **Total financial liabilities at amortised cost** | | **66 832** | **0** | **1 575 077** | **1 641 909** | **1 640 871** | **1 038** |

*Shares and fund units include the Group's subsidiary AS LHV Varahaldus investment into pension fund units in the amount of EUR 7 590 thousand (31.12.2017: EUR 6 261 thousand) euros. Pursuant to the Investment Funds Act, the mandatory shares of LHV Varahaldus as the management company is 0.5% (until 09.01.2017 1%) of the number of units in each of the mandatory pension fund managed by it.

The management board of the Group has assessed the fair value of assets and liabilities carried at amortized cost in the statement of financial position. For estimating fair value, the future cash flows are discounted based on the market interest yield curve.

**Levels used in hierarchy:**

1. Level 1 – quoted prices in active market
2. Level 2 – valuation technique based on observable market data as inputs (rates and interest curves from similar transactions)
3. Level 3 – other valuation techniques (as example discounted cashflow method) with significant unobservable inputs

**Valuation explanations**

Shares and fund units - Level 1 – quotes from active market. Level 2 - AS LHV Varahaldus' investments into pension fund units have quoted prices from the market, however the market is inactive and therefore these are classified as level 2 investments.

Equity instruments at fair value through other comprehensive income - the shares of Visa are not traded on an active market, therefore their value is based on market information on similar transactions and management estimates

Debt securities at fair value through profit or loss - Quotes from active market

Interest rate swaps and foreign exchange forwards - mainly positive market value of derivative contracts such as interest rate swaps, foreign exchange swaps and forwards. Markets supply observable inputs to the valuation model, which is used for establishing the fair value. The fair value for such over-the-counter derivatives is calculated as a theoretical net present value (NPV), based on independently sourced market parameters, assuming no risk and uncertainties. Market observable zero coupon yield curve is used for discounting in NPV calculations.

Due from other banks - Very liquid and short-term

Due from credit institutions - Very liquid and short-term

Due from investment companies - Very liquid and short-term

Loans and advances to customers – Long-term, significant level of judgements. Fair value of loans have been calculated using the average interest rate of past 6 months prior to balance sheet date

Receivables from customers - Short-term receivables

Other financial assets - Short-term deposits

Deposits from customers and loans received - customer deposits and loans received with fixed interest rates are primarily short-term and pricing of the deposits is subject to market conditions; as a result, the fair value of deposits determined using the discounted future cash flows do not significantly differ from their carrying amount

Subordinated debt - Bonds are listed, but liquidity is too low for using directly the market quotas. In addition, LHV is not allowed to buy these bonds back without FSA approval for every trade

Accounts payable and other liabilities - Short-term payables

For the term structure of financial assets and financial liabilities, refer to Note 3.4.

## 3.6 Operational risk

Operational risk is a potential loss caused by human, process or information system flaws. When completing transactions, transaction limits and competence systems are used to minimise potential losses and the segregation of duties principle is used in the Group's working procedures, according to which there should be an approval by at least two employees or units in order to carry out a transaction or procedure.

The information received from monitoring operating risk helps to gather initial information to secure capital adequacy of the Group and to evaluate capital requirements. The analysis of cases collected into the database enables the Group to identify the flaws in business processes, avoid making mistakes in the future and mitigate possible risks or define the terms of their acceptance. The risk control manager of Group is responsible for collecting information.

Compliance control and internal audit department have an important role in evaluating, monitoring and mitigating the operating risk. The main task of the Compliance Officer is to evaluate the activities of the Group in accordance with legislation, the supervision guidelines of the Financial Supervision Authority and procedure rules of the Group. Internal audit is an independent and objective function, assuring and consulting activity that is targeted at improving the Group's performance, processes and adding value. Internal audit helps achieving the goals of the Group, using a systematic and disciplined approach to assess and increase the efficiency of the risk management, control and organisational management process.

## 3.7. Compliance risk

Risk of compliance is the existing or potential risk to income and capital as a consequence of a failure to comply with laws, guidelines, standards or ethical principles. The realization of a risk may result in fines, claims, loss in reputation, termination of contractual relationships and, in revocation of the licence.

The aim of managing compliance risk is to prevent the negative consequences from materializing.

Considering the volume and pace of changes to regulatory requirements LHV assesses compliance risk to remain high.

In order to manage the risk, the compliance function assesses changes to regulatory environment, evaluates their potential impact, informs management of changes and participates in the implementation thereof.

Monthly overviews to management include information collected from various sources, including supervisory guidelines,, EU, UK and Estonian regulatory acts. Board members take responsibility in implementing identified changes. In addition, the compliance function keeps track of all regulatory requirements applicable to LHV group entities.

The biggest challenges that faced LHV in 2018 from regulatory perspective were implementation of MiFID II, IFRS 9, GDPR and changes to reporting requirements (AnaCredit), PSD 2, PRIIP regulation, 4MLD and guidelines issued for its implementation.

Considering recent events, incl. the cases of Danske and Versobank, LHV continues to pay particular attention to AML related measures.

## 3.8. Anti-money laundering

Structure of money laundering and terrorist financing risks

- Money laundering and terrorist financing risk. The risk that bank products or services will be used for money laundering or terrorist financing, which may be expressed through realization of compliance and/or reputational risk.
- Compliance risk. The risk that the Group will not be able to comply with obligations imposed by the regulations on money laundering and terrorist financing (especially the implementation of due diligence measures), which may lead to a fine or a revocation of a license.
- Reputational risk. The risk that the reputation of the Group is damaged by the actual or suspected involvement of money laundering or terrorist financing, as well as the realization of the compliance risk, and which may have a significant negative financial impact (loss of profit, decrease of value, etc.).
- Concentration risk. The risk that the structure of customers and their assets are significantly related to the criminal activities, which may express in realization of compliance and reputational risk.
- Group can be affected also by liquidity risk through realization and escalation of above-mentioned risks.

**AML/CTF Governance**

LHV has established internal AML/CTF governance system, which is based on three lines of defence principle where all defence lines are committed to actively mitigate ML/TF risk guided by risk-based approach. Risk based approach is based on risk assessment of products, services and clients and on risk-based monitoring. It is supported by high awareness and commitment from all employees and management built on awareness rising, information sharing and training and supported by appropriate reporting.

Management and Supervisory Board of LHV Group and LHV Bank have strong commitment towards implementing, maintaining and developing AML/KYC regime all over Group entities. There have been at least yearly updates in AML/CTF Policy and Customer Acceptance Principles. In addition, all internal AML/CTF procedures are constantly updated.

Beside updating internal regulations also strong focus is set on technical capabilities to prevent and detect money laundering, terrorist financing, financial fraud and international financial sanctions. One highlight in 2018 was started the implementation of two dedicated software solutions for screening and monitoring. Both tools are well-known trademarks in their area and will be fully implemented in first half of 2019. LHV uses Accuity`s Compliance Link for screening and FICO Tonbeller`s Siron for monitoring and risk segmentation. Additionally Bank has established cooperation with external experts with aim to continuously develop its analytical capabilities.

Not only there have been investments in to IT, but also to human resources. As regulations and expectations towards depth of KYC measures are constantly growing, then Group has significantly increased resources in that area. Comparing to 2017 Group has more than doubled number of employees directly involved with AML measures. Number of employees dealing directly with AML and KYC is planned to be increase in coming years.

### AML/KYC measures

LHV main principles:

- strong on-boarding customer due diligence supported by Customers Acceptance Principles;
- conservative approach towards risk segmentation;
- regular customer due diligence and enhanced customer due diligence;
- robust risk based monitoring;
- screening of customers and transactions towards International financial sanctions lists and other sources (incl. US OFAC list);
- strong top and middle management commitment;
- regular training of employees;
- ongoing communication and cooperation with FIU and other relevant stakeholders;
- active participation in setting industry`s best practices.

LHV has implemented four levels of customer acceptance in on-boarding stage:

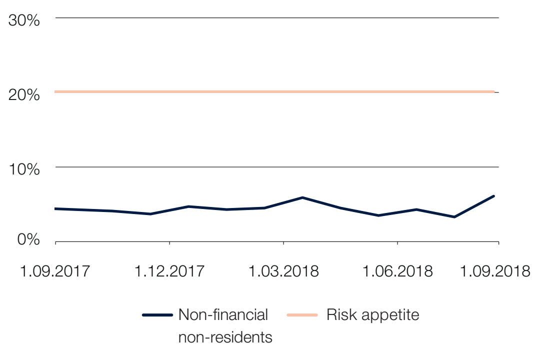
- Customer relationship manager
- Customer relationship manager and approval by senior employee (4-eye principle)
- Risk Customer Acceptance Committee
- Management Board

Combination of risk indicators determine with each customer which acceptance level is required.

Beside conservative and risk-based on-boarding procedures, also risk-based monitoring is implemented and regular updating of KYC information is carried out.

LHV has set risk tolerance towards non-resident legal customers' deposits outside of non-financial and non-governmental sectors to 20%. In reality, those numbers are significantly lower:

### Non-resident deposit ratio




One of first risk indicators is country and jurisdiction risk. LHV has four risk categories for countries which are based on money laundering and terrorist financing risks. Even EU member countries are not categorized in same way, but have different risk categories depending on their risks.

LHV welcomes country`s e-resident program, but all e-residents are still non-residents and require similar KYC measures as set to all other non-residents.

### Financial intermediaries

LHV is accepting as customers modern financial intermediaries or so called fin.tech companies who provide financial services to their customers. As such service providers are potentially presenting higher money laundering and terrorist financing risk, then Group has dedicated special attention and measures to service such customers. There are dedicated customer managers having area related competence. AML team is always keeping eye on new trends and threats coming from that sector and KYC measures are constantly updated. Group has taken approach that all customers from fin.tech sector have to have same AML/KYC measures in place as does banking sector.

During on-boarding and continuous KYC, Group assesses customers business model, team, AML/KYC measures, technical capabilities for screening and monitoring, customer focus, customer risk segmentation, limit policy, source of funds and etc. LHV carries out on-site visits to ensure that declared activities are really implemented and working. Special and continuous attention is set on financial activities of those customers.

**Country**

Through geographical location and historic connections there has been strong pressure from CIS countries to use neighbouring countries financial system as route for their finances to Western Europe. Recent public information demonstrates that there have been lack of strong KYC measures at least in two banks. Related to poor KYC measures that have led to the potential money laundering has FSA withdrawed a license from one bank in Estonia. Same reasons are behind of closure of non-resident business in one Scandinavian bank`s branch and limiting services in retail business.

Estonia adopted new AML/CTF law in the end of 2017. New law is based on fourth EU AML directive, but covers partially also requirements from fifth EU AML directive as well. FSA has adopted new AML guideline for financial sector based on new legislation. New FSA`s guideline is more detailed than previous ones and includes sample list of high risk situations financial industry should focus on. In general Estonian AML/CTF regulation is aligned with EU and FATF principles and is covering all new requirements (f.e. domestic PEP`s, register of beneficial owners, national and industry level risk assessment and etc.).

## 3.9. Other risks

### 3.9.1 Strategic and business risk

Strategic risk is expressed mainly in wrong strategic decisions. Strategic risk is mitigated through well-considered business plans and analyses. In addition, members of both LHV Pank’s and LHV Group’s management (both Management Board and Supervisory Board) have long-term experience in the banking sector and/or entrepreneurship. Prior to entering new markets and sectors, professionals in the field will always be involved and a thorough analysis will be carried out.

### 3.9.2 Risk on reputation

Risk on reputation is defined as a risk, which arises from a loss of reputation for clients, business partners, owners, investors or supervisors. Risk on reputation is usually a result from realization of other risks (for example operational risk or strategic risk). In order to mitigate the risk on reputation, LHV regularly carries out risk management trainings and also the framework of risk management is constantly improved which will provide a strong risk culture.

### 3.9.3 Country risk

Similarly to the risk on reputation, the country risk is usually expressed through another risk (operational risk, credit risk, strategic risk). In addition to Estonia, LHV is preparing to start a business in the United Kingdom.

## 3.10 Offsetting assets and liabilities

The group has offset the following assets and liabilities.

| 31.12.2018 | Gross amounts before offsetting in the statement of financial position | Offsetting | Net amount of exposure presented in the statement of financial position | Related arrangements not set off in the statement of financial position: Financial instruments | Related arrangements not set off in the statement of financial position: Cash collateral received | Net amounts |
|---|---|---|---|---|---|---|
| **ASSETS** | | | | | | |
| Derivatives | 59 | 0 | 59 | 0 | 0 | 0 |
| **LIABILITIES** | | | | | | |
| Derivatives | 11 | 0 | 11 | 0 | 0 | 0 |
| **31.12.2017** | | | | | | |
| **ASSETS** | | | | | | |
| Prepayments to merchants for registered customer contacts | 3 716 | -3 449 | 267 | 0 | 0 | 267 |
| Due from investment companies | 20 628 | -20 625 | 3 | 0 | 0 | 3 |
| Derivatives | 30 | 0 | 30 | 0 | 0 | 0 |
| **LIABILITIES** | | | | | | |
| Payables to merchants | 9 413 | -3 449 | 5 964 | 0 | 0 | 5 964 |
| Payables to investment companies | 20 625 | -20 625 | 0 | 0 | 0 | 0 |
| Derivatives | 2 | 0 | 2 | 0 | 0 | 0 |

## NOTE 4 Significant management estimates and assumptions

In accordance with IFRS, several financial figures presented in the financial statements are strictly based on critical accounting estimates and assumptions made by management, which affect the reported amounts of the assets and liabilities and disclosure of contingent assets and liabilities presented in the financial statements at the end of the reporting period, and the reported amounts of income and expenses of subsequent reporting periods. Although these estimates have been made to the best of management's knowledge and their judgement of current events, the actual outcome may ultimately not coincide with them and may significantly differ from these estimates. Management's estimates have been applied to valuation of loans, receivables and investments (Notes 10, 11, 12, 13 and 14) and the determination of useful lives of tangible and intangible assets (Note 16).

Estimates and judgments are continually evaluated based on historical experience and other factors, including expectations of future events that are believed to be reasonable in the circumstances. Changes in management's estimates are reported prospectively.

### EXPECTED CREDIT LOSS MODEL

The most significant management estimates and assumptions are related with the new financial instrument standard IFRS 9, namely the criteria for SICR, calculation of PD and LGD, business model and SPPI assessment for classification of financial assets. Please see more information in Note 3.2 and below.

When calculating expected credit loss (ECL) there are a number of key concepts that require a high level of judgement. Estimating expected credit loss is, by its very nature, uncertain and the accuracy of these estimates depends on many factors, e.g. macroeconomic forecasts and involves complex modelling and judgements. The assessment of significant increase in credit risk is a new concept under IFRS 9 Financial Instruments and will require significant judgement. At the end of each reporting period the Group shall perform an assessment of whether credit risk has increased significantly since initial recognition by considering the change in the risk of default occurring over the remaining life of the financial instrument, using key risk indicators that are used in the Group's existing risk management processes. Another area requiring significant judgement is the incorporation of forward-looking information and macroeconomic scenarios. IFRS 9 requires an unbiased and probability-weighted estimate of credit losses by evaluating a range of possible outcomes that incorporates forecasts of future economic conditions. LHV uses internally developed macroeconomic forecasts as the basis for the forward-looking information in the ECL measurement. LHV uses both models and expert based judgement in order to determine ECLs. The objective of applying expert based judgement is to incorporate the estimated impact of factors not captured in the modelled ECL. The degree of judgement that is required to estimate expected credit losses depends on the outcome from calculations, materiality and the availability of detailed information. The models, assessment and assumptions are regularly reviewed by the risk organisation of the Group and approved by the Group Risk Committee.

## NOTE 5 Business segments

Bank divides its business activities by 3 main business segments: retail banking, private banking and corporate banking. The business segments form a part of the Group, with a separate access to financial data and which are subject to regular monitoring of operating result by the Group's decision-maker. The full planning and KPI setting is done on segments level. For each of the segment full statement of financial position and profit and loss statement is prepared. In addition to these high-level segments, Group has planning/measurement on department level. Grouping is done based on the client/product base, where similar departments are grouped under one segment. Private banking covers high net worth customers, who's main product is investments. Retail banking segment covers all private individuals and small legal entities with credit exposure under EUR 250 thousand. This is the regular universal banking segment offering payments, cards, credits etc. Corporate banking segment covers all corporate customers and other legal entities with credit exposure over EUR 250 thousand. The main products are credits and payments. Asset management is the pension management segment covering pension second and third pillar. Hire-purchase unit in Estonia is separate legal entity covering small loan business to private individuals. These portfolios are relatively small, but due to clients different payment history these segments have to be looked separately. The management board of AS LHV Group has been designated as the decision-maker responsible for allocation of funds and assessment of the profitability of the business activities. The result posted by a segment includes revenue and expenditure directly related to the segment.

The revenue of a reported segment is based on the revenue per financial statements and includes gains from transactions between the segments, i.e. loans granted by AS LHV Pank to other group companies. The division of interest income and fee and commission income by customer location has been presented in Notes 7 and 8. The Group does not have any customers, whose income would account for more than 10% of the corresponding type of revenue.

| **31.12.2018** *(in thousands of euros)* | Retail banking | Private banking | Corporate banking | Asset management | Hire-purchase and consumer finance in Estonia | Other activities | Intra-segment eliminations | Total |
|---|---|---|---|---|---|---|---|---|
| Interest income incl. | 9 780 | 1 164 | 25 359 | 0 | 9 380 | 6 845 | -6 906 | 45 622 |
| External interest income | 6 802 | 0 | 24 125 | 0 | 9 380 | 5 315 | 0 | 45 622 |
| Internal interest income | 2 978 | 1 164 | 1 234 | 0 | 0 | 1 530 | -6 906 | 0 |
| Interest expense | 0 | 0 | -4 401 | -168 | -1 234 | -8 574 | 6 906 | -7 471 |
| **Net interest income** | **9 780** | **1 164** | **20 958** | **-168** | **8 146** | **-1 729** | **0** | **38 151** |
| Fee and commission income | 12 964 | 1 292 | 1 910 | 13 942 | 517 | 2 219 | 0 | 32 844 |
| Fee and commission expense | -6 953 | 0 | -65 | 0 | -553 | -228 | 0 | -7 799 |
| Dividend income | 0 | 0 | 0 | 0 | 0 | 6 578 | -6 578 | 0 |
| **Net fee and commission income** | **6 011** | **1 292** | **1 845** | **13 942** | **-36** | **8 569** | **-6 578** | **25 045** |
| **Net income** | **15 791** | **2 456** | **22 803** | **13 774** | **8 110** | **6 840** | **-6 578** | **63 196** |
| Net gains from financial assets | -15 | 0 | 0 | -25 | 0 | 483 | 0 | 443 |
| Administrative and other operating expenses, staff costs | -12 495 | -986 | -5 503 | -5 823 | -2 058 | -4 416 | 0 | -31 281 |
| Profit before credit losses | 3 281 | 1 470 | 17 300 | 7 926 | 6 052 | 2 907 | -6 578 | 32 358 |
| Impairment losses on loans and advances | 351 | 0 | -5 027 | 0 | -171 | -32 | 0 | -4 879 |
| **Profit before tax** | **3 632** | **1 470** | **12 273** | **7 926** | **5 881** | **2 875** | **-6 578** | **27 479** |
| Income tax | -479 | -84 | -987 | -1 100 | -838 | -126 | 0 | -3 614 |
| **Profit from continuing operations** | **3 153** | **1 386** | **11 286** | **6 826** | **5 043** | **2 749** | **-6 578** | **23 865** |
| **Total assets** | **1 005 454** | **94 412** | **535 836** | **31 193** | **51 383** | **127 748** | **-168 926** | **1 677 100** |
| **Total liabilities** | **1 105 619** | **238 898** | **177 086** | **2 610** | **39 577** | **51 380** | **-95 834** | **1 519 337** |

The geographical distribution of Group's interest income and its breakdown by products are presented in Note 7.

| **31.12.2017** *(in thousands of euros)* | Retail banking | Private banking | Corporate banking | Asset management | Hire-purchase and consumer finance in Estonia | Other activities | Intra-segment eliminations | Total |
|---|---|---|---|---|---|---|---|---|
| Interest income incl. | 7 509 | 1 018 | 19 567 | 2 | 8 201 | 4 640 | -5 443 | 35 494 |
| External interest income | 5 710 | 0 | 18 471 | 2 | 8 201 | 3 110 | 0 | 35 494 |
| Internal interest income | 1 799 | 1 018 | 1 096 | 0 | 0 | 1 530 | -5 443 | 0 |
| Interest expense | 0 | 0 | -3 720 | -168 | -1 095 | -5 593 | 5 443 | -5 133 |
| **Net interest income** | **7 509** | **1 018** | **15 847** | **-166** | **7 106** | **-953** | **0** | **30 361** |
| Fee and commission income | 10 529 | 988 | 1 094 | 13 293 | 485 | 13 | 0 | 26 402 |
| Fee and commission expense | -4 188 | 0 | -301 | 0 | -688 | -236 | 0 | -5 413 |
| Dividend income | 0 | 0 | 0 | 0 | 0 | 3 803 | -3 803 | 0 |
| Net fee and commission income | 6 341 | 988 | 793 | 13 293 | -203 | 3 580 | -3 803 | 20 989 |
| **Net income** | **13 850** | **2 006** | **16 640** | **13 127** | **6 903** | **2 627** | **-3 803** | **51 350** |
| Net gains from financial assets | -22 | 0 | 0 | 294 | 0 | 707 | 0 | 979 |
| Administrative and other operating expenses, staff costs | -10 353 | -1 094 | -4 995 | -6 663 | -1 668 | -2 771 | 0 | -27 544 |
| **Profit before credit losses** | **3 475** | **912** | **11 645** | **6 758** | **5 235** | **563** | **-3 803** | **24 785** |
| Impairment losses on loans and advances | -719 | 0 | -2 234 | 0 | -631 | 0 | 0 | -3 584 |
| Profit before tax | | | | | | | | |
| Income tax | 0 | 0 | 0 | -951 | 0 | 0 | 0 | -951 |
| **Profit from continuing operations** | **2 756** | **912** | **9 411** | **5 807** | **4 604** | **563** | **-3 803** | **20 250** |
| **Total assets*** | **1 061 023** | **99 630** | **565 451** | **19 128** | **43 255** | **97 496** | **-129 257** | **1 756 726** |
| **Total liabilities*** | **1 189 006** | **256 916** | **190 442** | **2 586** | **33 149** | **31 198** | **-66 899** | **1 636 398** |

*Total assets and total liabilities differ from the amounts recorded in consolidated statement of financial position due to elimination of discontinued operations (see also note 26). The geographical distribution of Group's interest income and its breakdown by products are presented in Note 7.

## NOTE 6 Subsidiaries and goodwill

As at 31.12.2018, the Group's subsidiaries, which have been consolidated in these financial statements include:

- AS LHV Pank
(Estonia, ownership interest 100%);
- AS LHV Varahaldus
(Estonia, ownership interest 100%);
- Cuber Technology OÜ
(Estonia, ownership interest 100%);
- AS LHV Finance (Estonia, ownership interest 65% through AS LHV Pank).

AS LHV Pank paid EUR 325 thousand euros of monetary contribution for 65% of ownership in LHV Finance and a non-controlling interest paid EUR 175 thousand euros of monetary contribution for 35% of ownership. The contribution of the non-controlling interest has been reflected in the consolidated statement of financial position on the line "Non-controlling interest".

As at 31.12.2018 and 31.12.2017, the Group does not have any associates.

As at 31.12.2018, goodwill in amount EUR 3 614 thousand in the consolidated financial statements of AS LHV Group consists of:

- positive goodwill which had arisen on the acquisition of the ownership interests in AS LHV Varahaldus in the amount of EUR 482 thousand;
- positive goodwill which had arisen after the conclusion of a purchase contract of AS LHV Varahaldus entered into in 2009 in the amount of EUR 562 thousand;
- positive goodwill which had arisen on the acquisition of the ownership interests in Danske Capital AS by AS LHV Varahaldus in the amount of EUR 2 570 thousand.

Impairment tests were performed as at 31.12.2018 and as at 31.12.2017. The cash-generating unit of goodwill is AS LHV Varahaldus. The calculation of the value in use is based on the following assumptions:

- the volume of assets under management is expected to increase by 16% per annum
(2017: by 15%);
- increase of income of fund manager is expected to be average of -10% per annum (2017: 8%);
- due to the economic environment, growth of 2% in indirect costs is expected per annum (2017: 6%);
- the discount rate used is 15% (2017: 15%).

When using the main assumptions, the management used previous years' experience and its best estimate in respect of probable expectations. Expectations are more conservative due to the changes in the market situation and legislation. Based on the results of the impairment test performed as at 31.12.2018 and 31.12.2017, the recoverable amount of cash generating unit is higher than its carrying amount, as a result of which no impairment losses have been recognized.

As at 31.12.2017, the Group had 2 subsidiaries that had non-controlling interests that were material to the Group. After selling UAB Mokilizingas in 2018, there is only AS LHV Finance left as at 31.12.2018.

Set out below are the summarised financial information for each subsidiary. The information disclosed is the amount before inter-company eliminations.

| | UAB Mokilizingas | | AS LHV Finance |
|---|---|---|---|
| **Summarised statement of Financial Position** | 31.12.2017 | 31.12.2018 | 31.12.2017 |
| Loans and advances to customers and other current assets | 53 915 | 51 338 | 43 209 |
| Non-current assets | 239 | 45 | 46 |
| Current liabilities | 8 727 | 1 996 | 2 192 |
| Non-current liabilities | 36 700 | 37 581 | 30 957 |
| **Total net assets** | **8 727** | **11 806** | **10 106** |

| **Summarised statement of Profit or Loss** | UAB Mokilizingas | | AS LHV Finance |
|---|---|---|---|
| **and Other Comprehensive Income** | 2017 | 2018 | 2017 |
| Total net interest and fee income | 6 332 | 8 110 | 6 902 |
| Profit before income tax | 2 224 | 5 881 | 4 604 |
| Income tax expense | -297 | -838 | 0 |
| Profit from discontinued operations | 0 | 0 | 0 |
| **Net profit** | **1 927** | **5 043** | **4 604** |
| Total comprehensive income | 1 927 | 5 043 | 4 604 |
| Profit and other comprehensive income allocated to non-controlling interests | 963 | 1 765 | 1 612 |

| | UAB Mokilizingas | | AS LHV Finance |
|---|---|---|---|
| **Summarised statement of Cash Flows** | 2017 | 2018 | 2017 |
| Cash generated from operations | -4 114 | -1 188 | -1 788 |
| Interest paid | -919 | -1 215 | -1 103 |
| Income tax paid | -297 | -838 | 0 |
| Net cash generated from/(used in) operating activities | -5 330 | -3 241 | -2 891 |
| Net cash generated from/(used in) investing activities | 0 | -28 | -26 |
| Net cash generated from/(used in) financing activities | 6 195 | 3 274 | 2 917 |
| **Net increase/(decrease) in cash and cash equivalents** | **865** | **5** | **0** |
| Cash and cash equivalents at beginning of year | 1 859 | 0 | 0 |
| Cash and cash equivalents at end of year | 2 724 | 5 | 0 |

## NOTE 7 Net interest income

| **Interest income** *(in thousands of euros)* | Note | 2018 | 2017 |
|---|---|---|---|
| Corporate loans | | 27 048 | 21 703 |
| incl. loans to related parties | 24 | 31 | 27 |
| incl. stage 3 interests* | | 340 | 421 |
| Hire purchase | | 4 055 | 4 128 |
| Consumer loans | | 5 313 | 4 018 |
| Leasing | | 2 439 | 1 845 |
| incl. loans to related parties | 24 | 4 | 6 |
| Private loans | | 1 514 | 1 161 |
| Mortgage loans | | 1 769 | 640 |
| Leveraged loans and lending of securities | | 456 | 147 |
| From debt securities | | 136 | 206 |
| incl. debt securities available-for-sale | 11a | 0 | 24 |
| incl. debt securities at FVOCI | 11b | 13 | 0 |
| incl. debt securities at fair value through profit or loss | 12 | 123 | 182 |
| Credit card loans | | 770 | 694 |
| From balances with credit institutions and investment companies | | 141 | 41 |
| Other loans | | 1 981 | 857 |
| **Total** | | **45 622** | **35 494** |

| **Interest expense** | | | |
|---|---|---|---|
| Deposits from customers and loans received | | -1 880 | -1 224 |
| incl. deposits from related parties | 24 | -42 | -41 |
| From balances with central bank | | -3 360 | -1 773 |
| Subordinated debt | 20 | -2 231 | -2 136 |
| incl. loans from related parties | 24 | -357 | -336 |
| **Total** | | **-7 471** | **-5 133** |
| **Net interest income** | | **38 151** | **30 361** |

**Interest income of loans by customer location**
**(interests from bank balances and debt securities not included):**

| *(in thousands of euros)* | 2018 | 2017 |
|---|---|---|
| Estonia | 44 822 | 34 307 |
| Lithuania | 523 | 940 |
| **Total** | **45 345** | **35 247** |

*As most of the stage 3 loans are sold to debt collectors, the stage 3 interests are marginal in all loan portfolios except corporate loans.

## NOTE 8 Net fee and commission income

| Fee and commission income | Note | 2018 | 2017 |
|---|---|---|---|
| Security brokerage and commission fees | | 3 687 | 3 081 |
| incl. related parties | 24 | 11 | 11 |
| Asset management and related fees | | 16 371 | 14 983 |
| Incl. funds managed by the Group* | 24 | 13 922 | 13 275 |
| Currency exchange fees | | 1 639 | 977 |
| Fees from cards and settlements | | 8 766 | 5 875 |
| Commission fees from partners | | 0 | 0 |
| Fees from consumer loans and hire purchase | | 518 | 485 |
| Other fee and commission income | | 1 863 | 1 001 |
| **Total** | | **32 844** | **26 402** |
| **Fee and commission expense** | | | |
| Security brokerage and commission fees paid | | -544 | -64 |
| Expenses related to cards | | -2 765 | -2 026 |
| Expenses related to acquiring | | -2 834 | -1 982 |
| Transaction costs | | -468 | -301 |
| Costs related to ATM-s | | -649 | -203 |
| Other fee expense | | -539 | -837 |
| **Total** | | **-7 799** | **-5 413** |
| **Net fee and commission income** | | **25 045** | **20 989** |

* Commission fees from pension and investment funds are calculated as a fixed percentage of total assets of the fund and varies between 0.39% -2% p.a. Starting from September 2019 the funds fixed comission fees will decrease, but funds will be allowed to take success fee.

| Fee and commission income by customer location: | 2018 | 2017 |
|---|---|---|
| Estonia | 32 677 | 26 123 |
| Latvia | 0 | 50 |
| Lithuania | 0 | 71 |
| Other | 163 | 202 |
| **Total** | **32 884** | **26 446** |

## NOTE 9 Operating expenses

| *(in thousands of euros)* | 2018 | 2017 |
|---|---|---|
| Wages, salaries and bonuses | 12 190 | 9 873 |
| Social security and other taxes* | 3 566 | 3 118 |
| **Total staff costs** | **15 756** | **12 991** |
| IT expenses | 2 322 | 1 743 |
| Information services and banking services | 625 | 567 |
| Marketing expenses | 2 023 | 3 656 |
| Office expenses | 677 | 456 |
| Transportation and communication costs | 225 | 222 |
| Training and travelling expenses of employees | 626 | 475 |
| Other outsourced services | 3 136 | 2 807 |
| Other administrative expenses | 2 304 | 1 949 |
| Depreciation | 2 972 | 1 297 |
| Operating lease payments | 1 153 | 1 027 |
| Other operating expenses | 324 | 208 |
| **Total other operating expenses** | **16 387** | **14 407** |
| **Total operating expenses** | **32 143** | **27 398** |

* lump-sum payment of social, health and other insurances.

The average number of employees working for LHV Group in 2018 was 366 (2017: 357).

From 2018, the sales costs of pension fund client agreements have been capitalised as intangible assets based on their expected lifetime of custome relationship, ie 20 years. Previously, the sales costs were recorded in "Marketing expenses" line item between 2002 to 2017, see also notes 2.1 (a), 2.9, 16 and 21. Under IAS 18, these costs were not capitalised as the expenses were allowed to be capitalised only until the customer had first opportunity to change pension fund, ie the time perion was shorter than 1 year.

If these sales costs would have recorded as costs and not capitalised as per IAS 18, the "Marketing expenses" would have been EUR 1 818 thousand higher.

## NOTE 10 Due from central bank, credit institutions and investment companies

| *(in thousands of euros)* | 31.12.2018 | 31.12.2017 |
|---|---|---|
| Demand and term deposits with maturity less than 3 months * | 42 796 | 40 498 |
| Statutory reserve capital at central bank | 14 280 | 15 375 |
| Demand deposit from central bank * | 625 582 | 905 339 |
| **Total** | **682 658** | **961 212** |
| * cash and cash equivalents in the statement of cash flows | 668 378 | 945 837 |

Distribution of receivables by countries is presented in Note 3.5. Mandatory banking reserve as at 31.12.2018 was 1% (2017: 1%) of all financial resources collected (deposits from customers and loans received). The reserve requirement is to be fulfilled as a monthly average in euros or in the foreign securities preapproved by the central bank.

## NOTE 11a Available-for-sale financial assets

As of 31.12.2017 the Group had VISA shares in the amount of EUR 220 thousand. As of 31.12.2017 the Group had also available-for-sale debt securities portfolio consisting of bonds in the amount of EUR 555 thousand. The balance of other reserves in equity as at 31.12.2017 is EUR 36 thousand, see also Note 21.

In 2017, no gains or losses arose from the sale of debt securities.

| | |
|---|---|
| **Available-for-sale financial assets 31.12.2016** | **799** |
| Proceeds from disposal and maturities of assets available-for-sale | -124 |
| Interest income (Note 7) | 24 |
| Revaluation of available-for-sale assets | 76 |
| **Available-for-sale financial assets 31.12.2017** | **775** |

## NOTE 11b Equity and debt instruments at fair value through other comprehensive income

| | |
|---|---|
| **Equity instruments 31.12.2017** | **0** |
| Reclassification on 1 January 2018 | 220 |
| Revaluation of equity instruments | 78 |
| **Equity instruments 31.12.2018** | **298** |

On 1 January 2018, the VISA shares were recorded as fair value throught other comprehensive income, which is irrevocable election by management as these shares are not held for trading.

As of 31.12.2018 the Group has VISA shares in the amount of EUR 298 thousand. The balance of other reserves in equity as at 31.12.2018 is EUR 78 thousand, see also Note 21.

On 1 January 2018, debt securities classified as FVOCI was based on the management assessment of the instrument's business model. Therefore, fair value through other comprehensive income measurement basis was applied at the application of IFRS 9.

| | |
|---|---|
| **Debt instruments 31.12.2017** | **0** |
| Reclassification on 1 January 2018 | 555 |
| Proceeds from disposal and maturities of assets available-for-sale | 556 |
| Interest income (Note 7) | 17 |
| Revaluation of debt instruments | -16 |
| **Debt instruments 31.12.2018** | **0** |

## NOTE 12 Financial assets and liabilities at fair value through profit or loss

| **Mandatory measurement as fair value through profit or loss:** | **31.12.2018** |
|---|---|
| Shares and fund units | 510 |
| Debt securities | 38 697 |
| Fund units | 7 590 |
| incl. investments in managed pension funds | 7 590 |
| Foreign exchange forwards | 59 |
| **Total financial assets** | **46 856** |
| Interest rate swaps and foreign exchange forwards | 11 |
| **Total financial liabilities** | **11** |

| **Securities held for trading:** | **31.12.2017** |
|---|---|
| Shares and fund units | 430 |
| Debt securities | 49 138 |
| | |
| **Designated as at fair value through profit or loss upon initial recognition:** | |
| Fund units | 6 261 |
| incl. investments in managed pension funds | 6 261 |
| Foreign exchange forwards | 30 |
| **Total financial assets** | **55 859** |
| Interest rate swaps and foreign exchange forwards | 2 |
| **Total financial liabilities** | **2** |

| **Financial assets at fair value through profit or loss 31.12.2016** | **75 391** |
|---|---|
| Net changes of investment securities at fair value through profit or loss | -19 962 |
| Interest income (Note 7) | 182 |
| Revaluation | 248 |
| **Financial assets at fair value through profit or loss 31.12.2017** | **55 859** |
| Net changes of investment securities at fair value through profit or loss | -10 335 |
| Interest income (Note 7) | 123 |
| Revaluation | 1 209 |
| **Financial assets at fair value through profit or loss 31.12.2018** | **46 856** |

Bid price is the fair value of investments in the case of publicly listed securities (Note 3.6). In 2018, a gain of EUR 407 thousand was recognised on the revaluation of debt securities (2017: EUR 440 thousand). No profit or loss arose on the revaluation of interest rate swaps in 2018 (2017: loss EUR 0 thousand).

The volume of pension and investment fund assets managed by the Group as at 31.12.2018 was EUR 1 214 million (31.12.2017: EUR 1 103 million).

## NOTE 13 Loans and advances to customers

| *(in thousands of euros)* | 31.12.2018 | 31.12.2017 |
|---|---|---|
| **Loans to legal entities** | **714 335** | **548 424** |
| incl. corporate loans | 624 425 | 456 748 |
| incl. retail loans | 16 200 | 13 656 |
| incl. leasing | 44 277 | 33 840 |
| incl. overdraft | 23 846 | 39 192 |
| incl. leveraged loans | 1 997 | 4 547 |
| incl. hire-purchase | 249 | 269 |
| incl. credit card loans | 274 | 172 |
| incl. credit letters | 3 067 | 0 |
| **Loans to individuals** | **214 702** | **191 744** |
| incl. hire-purchase | 17 501 | 57 327 |
| incl. mortgage loans | 101 009 | 77 640 |
| incl. consumer loans | 33 989 | 34 474 |
| incl. private loans | 37 884 | 0 |
| incl. leasing | 15 888 | 11 402 |
| incl. leveraged loans | 1 733 | 2 621 |
| incl. credit card loans | 6 579 | 8 199 |
| incl. overdraft | 43 | 81 |
| incl. study loan | 76 | 0 |
| **Total** | **929 037** | **740 168** |
| incl. related parties (note 24) | 3 328 | 2 820 |
| Impairment provisions | -10 276 | -8 125 |
| **Total** | **918 761** | **732 043** |

As at 31.12.2017, leverage loans included repo loans in the amount of EUR 778 thousand. The fair value of collaterals for repo loans as at 31.12.2017 was EUR 1 832 thousand. As at 31.12.2018, there were no repo loans.

| **Changes in impairments in 2018** | Corporate loans incl overdraft | Retail loans | Consumer loans | Credit cards | Hire-purchase | Leasing | Leve-raged loans | Other loans incl mortgage | Credit letters | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| **Balance as at 1 January** | **-4 594** | **-155** | **-1 255** | **-240** | **-858** | **-780** | **0** | **-243** | **0** | **-8 125** |
| Impairment provisions/ reversals set up during the year | -4 272 | -54 | 226 | 47 | 91 | 183 | -3 | 207 | -100 | -3 675 |
| Incl Changes in initial application of IFRS 9 | -403 | -46 | -53 | -2 | -50 | -158 | 0 | 0 | 0 | -712 |
| Written off during the year | 115 | 25 | 25 | 10 | 4 | 120 | 0 | 0 | 0 | 299 |
| Discontinued operations | 0 | 0 | 436 | 156 | 623 | 10 | 0 | 0 | 0 | 1 225 |
| **Balance as at December 31** | **-8 751** | **-184** | **-568** | **-27** | **-140** | **-467** | **-3** | **-36** | **-100** | **-10 276** |

| **Changes in impairments in 2017** | Corporate loans incl overdraft | Retail loans | Consumer loans | Credit cards | Hire-purchase | Leasing | Leve-raged loans | Other loans incl mortgage | Total |
|---|---|---|---|---|---|---|---|---|---|
| **Balance as at 1 January** | **-2 338** | **-101** | **-1 599** | **-118** | **-1 223** | **-219** | **0** | **-143** | **-5 741** |
| Impairment provisions set up during the year | -2 257 | -54 | -196 | -157 | -843 | -570 | 0 | -100 | -4 177 |
| Written off during the year | 1 | 0 | 540 | 35 | 1 208 | 9 | 0 | 0 | 1 793 |
| **Balance as at December 31** | **-4 594** | **-155** | **-1 255** | **-240** | **-858** | **-780** | **0** | **-243** | **-8 125** |

Impairment losses accumulated during the year differ from the amount of impairment losses recognized in the statement of profit or loss, that have been written off earlier as uncollectible claims. These receipts were recorded among impairment losses in the statement of profit or loss.

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| **Net and gross investments on finance leases according to remaining maturity** | Gross investment | Unearned future interest income | Impair-ment loss provision | Present value of lease payments receivable |
|---|---|---|---|---|
| up to 1 year | 19 135 | -1 710 | -134 | 17 291 |
| 1-5 years | 43 901 | -2 535 | -319 | 41 047 |
| over 5 years | 1 880 | -39 | -14 | 1 827 |
| **Total as at 31.12.2018** | **64 916** | **-4 284** | **-467** | **60 165** |
| | | | | |
| up to 1 year | 15 846 | -1 274 | -635 | 13 937 |
| 1-5 years | 32 406 | -1 756 | -142 | 30 508 |
| over 5 years | 820 | -20 | -4 | 796 |
| **Total as at 31.12.2017** | **49 072** | **-3 050** | **-780** | **45 242** |

For credit risk exposures and loan collateral, see Note 3.2.
Distribution of loans granted by currencies is disclosed in Note 3.3.
Distribution of loans granted by maturity is disclosed in Note 3.4.
The geographical distribution of loans granted is disclosed in Note 3.5.
For interest income on loans granted, see Note 7.

## NOTE 14 Receivables from customers

| *(in thousands of euros)* | 31.12.2018 | 31.12.2017 |
|---|---|---|
| Asset management fees from customers | 1 412 | 1 179 |
| incl. related parties (Note 24) | 1 227 | 1 156 |
| Other fees for providing services to customers | 2 309 | 7 302 |
| Payments in transit | 0 | 6 |
| Other receivables | 0 | 1 313 |
| **Total** | **3 721** | **9 800** |

All fees are collected within 12 months of the end of the reporting period and are considered as current asset.

## NOTE 15 Other assets

| *(in thousands of euros)* | 31.12.2018 | 31.12.2017 |
|---|---|---|
| **Financial assets** | | |
| Guarantee deposits of Baltic stock exchanges | 11 | 9 |
| Guarantee deposits of VISA and MasterCard | 2 925 | 2 280 |
| **Subtotal** | **2 936** | **2 289** |
| | | |
| **Non-financial assets** | | |
| Prepayments to Financial Supervision Authority | 476 | 446 |
| Tax prepayments | 0 | 10 |
| Repossessed assets | 0 | 22 |
| Prepayments to merchants for registered customer contracts | 0 | 52 |
| Other prepayments * | 1 175 | 986 |
| **Subtotal** | **1 651** | **1 516** |
| **Total** | **4 587** | **3 805** |

* Prepayments include office rent, insurance, communication services, periodicals and training.

Prepayments are expected to be received or used within 12 months of the end of the reporting period, and are therefore considered current assets. Guarantee deposits on the Baltic stock exchanges are held to guarantee securities trading activity on the stock exchanges of Tallinn, Riga and Vilnius and the deposits of VISA and MasterCard to guarantee credit card transactions, and should therefore both be considered non-current assets.

## NOTE 16 Tangible and intangible assets

| *(in thousands of euros)* | Tangible assets | Intangible assets | Costs incurred for the acquisition of cutomer contracts | Total intangible assets | Total |
|---|---|---|---|---|---|
| **Balance as at 31.12.2016** | | | | | |
| Cost | 3 521 | 7 210 | 0 | 7 210 | 10 731 |
| Accumulated depreciation and amortisation | -2 330 | -2 710 | 0 | -2 710 | -5 040 |
| **Carrying amount** | **1 191** | **4 500** | **0** | **4 500** | **5 691** |
| Purchase of non-current assets | 618 | 848 | 0 | 848 | 1 466 |
| Depreciation/amortisation charge | -327 | -1 021 | 0 | -1 021 | -1 348 |
| Non-current assets sold | -61 | 0 | 0 | 0 | -61 |
| **Balance as at 31.12.2017** | | | | | |
| Cost | 4 078 | 8 058 | 0 | 8 058 | 12 136 |
| Accumulated depreciation and amortisation | -2 657 | -3 731 | 0 | -3 731 | -6 388 |
| **Carrying amount 31.12.2017** | **1 421** | **4 327** | **0** | **4 327** | **5 748** |
| IFRS15 first time adoption | 0 | 0 | 10 618 | 10 618 | 10 618 |
| **Corrected carrying amount 31.12.2017** | **1 421** | **4 327** | **10 618** | **14 945** | **16 366** |
| Purchase of non-current assets | 396 | 1 236 | 0 | 1 236 | 3 450 |
| Capitalized selling costs | 0 | 0 | 1 818 | 1 818 | 0 |
| Write-off of non-current assets | -5 | 0 | 0 | 0 | -5 |
| Depreciation/amortisation charge | -510 | -1 031 | - 1 431 | -2 462 | -2 972 |
| Assets of discontinued operations | 340 | 371 | 0 | 371 | 711 |
| Amortisation of discontinued operations | -168 | -304 | 0 | -304 | -472 |
| **Balance as at 31.12.2018** | | | | | |
| Cost | 4 129 | 15 324 | 12 436 | 27 760 | 31 889 |
| Accumulated depreciation and amortisation | -2 994 | -10 859 | -1 431 | 12 290 | -15 284 |
| **Carrying amount** | **1 135** | **4 465** | **11 005** | **15 470** | **16 605** |

Tangible assets include computer technology and office equipment, furniture, capitalized costs of office renovation. Intangible assets include licences, client contracts and development costs.

In 2018 and 2017, there was no indication of impairment of tangible and intangible assets.

## NOTE 17 Deposits from customers and loans received

**31.12.2018**
*(in thousands of euros)*

| | Individuals | Financial intermediates | Legal entities | Public sector | Total |
|---|---|---|---|---|---|
| Demand deposits | 374 491 | 193 893 | 727 803 | 7 935 | 1 304 122 |
| Term deposits | 57 605 | 0 | 54 456 | 5 734 | 117 795 |
| Loans received | 0 | 0 | 21 528 | 0 | 21 528 |
| Accrued interest liability | 197 | 0 | 131 | 9 | 337 |
| **Total** | **432 293** | **193 893** | **803 918** | **13 678** | **1 443 782** |
| incl. related parties (Note 24) | 1 091 | 0 | 32 417 | 0 | 33 508 |

**31.12.2018**
*(in thousands of euros)*

| | Individuals | Financial intermediates | Legal entities | Public sector | Total |
|---|---|---|---|---|---|
| Demand deposits | 278 430 | 606 600 | 518 346 | 6 203 | 1 409 579 |
| Term deposits | 51 075 | 0 | 70 221 | 5 816 | 127 112 |
| Loans received | 0 | 0 | 6 000 | 0 | 6 000 |
| Accrued interest liability | 144 | 0 | 87 | 7 | 238 |
| **Total** | **329 649** | **606 600** | **594 654** | **12 026** | **1 542 929** |
| incl. related parties (Note 24) | 2 022 | 0 | 20 973 | 0 | 22 995 |

In 2017, a loan received from the Rural Development Foundation in the amount of EUR 778 thousand was returned. LHV Pank concluded an unsecured 10-year loan agreement with the European Investment Fund (EIF) in the amount of EUR 12.5 million to increase the credit facilities of small and medium-sized enterprises. As at 31.12.2018, the Bank had used EUR 12 250 thousand of the loan amount.

The nominal interest rates of most deposits from customers and loans received equal their effective interest rates as no other significant fees have been paid.

Distribution of deposits from customers and loans received by currency is presented in Note 3.3.

Distribution of deposits from customers and loans received by maturity is presented in Note 3.4.

Distribution of deposits from customers and loans received by geography and Risk concentration is presented in Note 3.2.2.

## NOTE 18 Accounts payable and other liabilities

*(in thousands of euros)*

| **Financial liabilities** | Note | 31.12.2018 | 31.12.2017 |
|---|---|---|---|
| Trade payables | | 2 153 | 8 507 |
| Payables to merchants | | 0 | 439 |
| Other short-term financial liabilities | | 1 925 | 1 878 |
| Accrued interest on subordinated loans | 20 | 314 | 210 |
| Payments in transit | | 16 800 | 55 661 |
| Financial guarantee contracts issued | | 236 | 137 |
| **Subtotal** | | **21 428** | **66 832** |
| **Non-financial liabilities** | | | |
| Performance guarantee contracts issued | | 243 | 159 |
| Tax liabilities | | 1 218 | 700 |
| Payables to employees | | 1 488 | 1 238 |
| incl. related parties | 24 | 91 | 84 |
| Other short-term liabilities | | 276 | 2 141 |
| **Subtotal** | | **3 216** | **4 238** |
| **Total** | | **24 644** | **71 070** |

Payables to employees consist of unpaid salaries, bonus accruals and vacation pay accrual for the reporting period and the increase in liabilities is caused by the increase in the number of employees during the year. Payments in transit consist of foreign payments and payables to customers related to intermediation of securities transactions, for which the customer's current account have been debited. All liabilities, except for financial guarantees, are payable within 12 months and are therefore recognised as current liabilities.

## NOTE 19 Operating lease

The Group leases office premises under the operating lease terms. All lease agreements are cancellable upon the consent of both parties. The minimum unilaterally non-cancellable lease payable in the next period are disclosed in the table below. In 2018, the operating lease payments for office premises were in the amount of EUR 1 153 thousand (2017: EUR 1 170 thousand).

| *(in thousands of euros)* | Up to 1 year | 1 to 5 year | Total |
|---|---|---|---|
| Non-cancellable lease payables as of **31.12.2018** | 987 | 3 525 | **3 525** |
| Non-cancellable lease payables as of **31.12.2017** | 1 195 | 2 152 | **3 347** |

## NOTE 20 Subordinated debts

According to the Groups operations, only subordinated debts are recognized as loans received in the statement of cash flows, as other loans are received as part of ordinary business operations. The current note contains changes in subordinated debts, including monetary or non-monetary movements and effects of foreign exchange rates, if they have occurred during the reporting period or the reference period.

The Group has received subordinated debts in order to increase long-term capital. In the case of default of the Group, the subordinated debts are repayable after all other debts have been paid, but before debts to shareholders are paid. The balances of subordinated debt as at the end of each reporting period is disclosed in the table below.

**Subordinated debts**
*(in thousands of euros)*

| | Year of issue | Amount | Interest rate | Maturity date |
|---|---|---|---|---|
| | 2014 | 15 900 | 7.25% | June 20, 2024 |
| | 2015 | 15 000 | 6.5% | October 29, 2025 |
| | 2018 | 20 000 | 6.0% | November 28, 2028 |
| Subordinated debt as at 31.12.2016 | | 30 900 | | |
| Subordinated debt as at 31.12.2017 | | 30 900 | | |
| Subordinated debt as at 31.12.2018 | | 50 900 | | |

Interest expenses on subordinated bonds for each reporting period and accrued interest liabilities as at the end of each reporting period is disclosed in the table below. Interest liabilities are accounted in the statement of financial position using the effective interest rate.

**Accrued interest on subordinated debt**
*(in thousands of euros)*

| | |
|---|---|
| **Accrued interest on subordinated debts as at 31.12.2016 (Note 18)** | **210** |
| Interest calculated for 2017 (Note 7) | 2 136 |
| Paid out during 2017 | -2 136 |
| **Accrued interest on subordinated debts as at 31.12.2017 (Note 18)** | **210** |
| Interest calculated for 2018 (Note 7) | 2 231 |
| Paid out during 2018 | -2 127 |
| **Accrued interest on subordinated debts as at 31.12.2018 (Note 18)** | **314** |

## NOTE 21 Shareholders' equity in the public limited company

**Transactions with share capital and share premium**

| | Time | Share price | Number of shares | Share premium | Total |
|---|---|---|---|---|---|
| **Share capital as at 31.12.2016** | | | **25 356** | **45 892** | |
| Paid in share capital | July 2017 | 2.0 | 411 | 412 | 823 |
| **Share capital as at 31.12.2017** | | | **25 767** | **46 304** | |
| Paid in share capital | July 2018 | 2.4 | 249 | 349 | 598 |
| **Share capital as at 31.12.2018** | | | **26 016** | **46 653** | |

Share capital is paid in full through cash contributions. The nominal value of the shares is 1 euro and as at 31.12.2018 the number of shares amounted to 26 016 485 (31.12.2017: 25 767 342). Each share gives one vote to the shareholder at the general meeting.

According to AS LHV Group's articles of association, the minimum share capital is EUR 15 million and the maximum share capital is EUR 60 million (31.12.2017: EUR 15 and EUR 60 million).

Rain Lõhmus who owns 24.9% of the voting rights and Andres Viisemann who owns 9.8% of the voting rights in AS LHV Group have significant influence over the company (31.12.2017: 25.14% and 9.87%).

In the reporting year, the Group paid dividends to shareholders of 0.16 (2017: 0.15) EUR per share, amounting to a total of EUR 4 123 (2017: 3 803) thousand.

As at 31.12.2018, the retained earnings of the Group totalled EUR 75 430 thousand (31.12.2017: EUR 44 071 thousand). As of 31.12.2018 it is possible to pay out dividends in amount EUR 60 426 (2017: 35 257) thousand. Part of the potential dividends (1/3 from dividends paid out in 2018) would be taxed at a preferential rate of 14/86 and the remaining part 20/80. The related income tax charge would be EUR 15 004 (2017: 8 814 with 20/80 tax rate) thousand.

**Statutory reserve capital in equity is as follows:**

| *(in thousands of euros)* | |
|---|---|
| **Statutory reserve as at 31.12.2016** | **1 580** |
| Transferred from 2016 net profit | 891 |
| **Statutory reserve as at 31.12.2017** | **2 471** |
| Transferred from 2017 net profit | 980 |
| **Statutory reserve as at 31.12.2018** | **3 451** |

On 1 January 2018, due to the initial application of IFRS 15, sales costs related with new client agreements from 2002 to 2017 that previously were recorded as "Marketing expenses" in Operating expenses in gross amount EUR 17 109 thousand and with accumulated depreciation of EUR 6 401 thousand, were capitalised. Therefore, as at 01.01.2018 the carrying amount of EUR 10 618 thousand were recorded in retained earnings, see also notes 2.1 (a), 2.9, 9 and 16.

Other reserves in the consolidated statement of Changes in Equity consist of:

| *(in thousands of euros)* | 31.12.2018 | 31.12.2017 |
|---|---|---|
| Revaluation reserve of available-for-sale securities | 0 | 36 |
| Revaluation reserve of equity instruments at fair value through other comprehensive income | 78 | 0 |
| Reserve of share options granted to staff | 2 012 | 1 413 |
| **Total** | **2 090** | **1 449** |

The Group is granting share options to the members of the Management Board and employees considered as such and department managers and employees considered as such of group companies that are part of AS LHV Group.

| | Number of shares | Strike price per share (EUR) | Weighted average share price of the exercise period | Expiry year | Number of people to whom the share options were granted |
|---|---|---|---|---|---|
| **Outstanding amount of share options at 31.12.2013** | **0** | | | | |
| Granted amount during the period | 411 336 | 2.0 | | 2017 | 35 |
| **Outstanding amount of share options at 31.12.2014** | **411 336** | | | | |
| Granted amount during the period | 278 594 | 2.4 | | 2018 | 48 |
| **Outstanding amount of share options at 31.12.2015** | **689 930** | | | | |
| Granted amount during the period | 270 330 | 3.0 | | 2019 | 48 |
| Cancelled amount during the period | -62 183 | | | | |
| **Outstanding amount of share options at 31.12.2016** | **898 077** | | | | |
| Granted amount during the period | 364 990 | 4.65 | | 2020 | 69 |
| Exercised amount during the period | -411 336 | | 10.23 | | |
| **Outstanding amount of share options at 31.12.2017** | **851 731** | | | | |
| Granted amount during the period | 299 781 | 5.33 | | 2021 | 72 |
| Exercised amount during the period | -278 594 | | 10.93 | | |
| **Outstanding amount of share options at 31.12.2018** | **872 918** | | | | |

The Group may issue share options for the results of 2018. The vesting period for all share options in the option program is 3 years. The right to subscribe will occur on the first day of the exercising period. In 2018, share options issued in 2015 were fully exercised.

The members of the Management Board and employees do not have the possibility to take the specified amount in cash in lieu of the share options. Share options cannot be exchanged, sold, pledged or encumbered. Share options can be inherited. The contract for share options will expire upon premature termination of the employment contract on the employee's initiative, for which exceptions can be made by the Supervisory Board of AS LHV Group or the Remuneration Committee based on the decision of the Supervisory Board, and upon extraordinary termination of the employment contract by the employer due to reasons resulting from the employee. According to the Credit Institutions Act the Supervisory Board of AS LHV Group can reduce the number of share options issued or cancel the share options if the overall financial results of the Company have significantly deteriorated compared to the previous period, the member of the Management Board or employee no longer meets the performance criteria, the Company no longer meets the prudential regulations or the Company's business risks are not adequately covered by Company's own funds or the performance fee has been determined based on information, which proved to be substantially misstated or incorrect.

Total expenses arising from share-based payment transactions amounted to EUR 1 208 (2017: 959) thousand.

## NOTE 22 Assets under management

**AS LHV Pank, operating as an account manager for its customers, has custody of or intermediates the following customer assets:**

| *(in thousands of euros)* | 31.12.2018 | 31.12.2017 |
|---|---|---|
| Cash balance of customers | 9 773 | 10 266 |
| Securities of customers | 1 383 157 | 1 193 235 |
| incl. shareholders of the parent company and related entities (Note 24) | 156 961 | 168 637 |
| **Total** | **1 392 930** | **1 203 501** |

Asset management fees for the management of these assets have been in the range of 0.015 – 0.025 % p.a. (for respective income, see Note 8).

The monetary funds of the customers who use the platform of an active securities trader or the trading system LHV Trader offered by the Bank, have been recognised as off-balance sheet assets. Due to the nature of the system, the Bank has deposited these funds in personalised accounts with its partner and as the monetary funds of these customers are not used for business purposes by the Bank (they cannot be lent to other customers or used as collateral), therefore the monetary funds are recognised as off-balance sheet assets. The Bank earns commission and interest income on intermediation of transactions in these accounts similarly to customers' accounts reflected in the Group's financial statement. The Bank has provided contractual guarantees to its partner in respect of LHV Trader accounts, guaranteeing potential losses to be incurred from financing of the transactions executed by customers intermediated by itself (leveraging), with the primary collateral being the securities used as collateral for leveraged loans. The customer has similar guarantee to the Bank and therefore, the Bank has in substance transferred the guarantee to end customer. To avoid potential losses, the Bank has a daily practice to monitor the potential decrease of collateral and deficiency of customer accounts. In its current practice, no such losses in respect of which the guarantee provided by the Bank would apply have incurred and the Bank has not paid any compensation relating to the guarantee.

## NOTE 23 Contingent assets and liabilities

| **Non-cancellable agreements** | Performance guarantees | Financial guarantees | Letters of credit | Unused loan commitments | Total |
|---|---|---|---|---|---|
| Liability in contractual amount 31.12.2018 | 11 927 | 9 314 | 55 | 188 841 | 210 137 |
| Liability in contractual amount 31.12.2017 | 10 129 | 5 999 | 51 | 179 572 | 195 751 |

With the initial application of IFRS 9, financial guarantees and unused loan commitments are subject to ECL, see also note 3.2 for more information.

Tax authorities have the right to review the company's tax records for up to 5 years after submitting the tax declaration and upon finding errors, impose additional taxes, interest and fines. The tax authorities have not performed any tax audits at the Group during 2017-2018. The Group's management estimates that in 2019 there are no such circumstances which may lead the tax authorities to impose significant additional taxes on the Group.

Performance guarantees are contracts that provide compensation if another party fails to perform a contractual obligation. Such contracts do not transfer credit risk. The risk under performance guarantee contracts is the possibility that the insured event (i.e. the failure to perform the contractual obligation by another party) occurs. The key risks the Group faces are significant fluctuations in the frequency and severity of payments incurred on such contracts relative to expectations. The Group uses historical data and statistical techniques to predict levels of such payments. Claims must be made before the contract matures and most claims are settled within short term. This allows the Group to achieve a high degree of certainty about the estimated payments and therefore future cash flows. The Group manages such risks by constantly monitoring the level of payments for such products and has the ability to adjust its fees in the future to reflect any change in claim payments experience. The Group has a claim payment requests handling process, which includes the right to review the claim and reject fraudulent or non-compliant requests. The exposure and concentration of performance guarantees expressed at the amounts guaranteed is as follows:

| According to sectors | 31.12.2018 | 31.12.2017 |
|---|---|---|
| Construction | 6 594 | 7 083 |
| Water supplies | 2 600 | 1 237 |
| Manufacturing | 623 | 212 |
| Professional, scientific and technical activities | 1 157 | 708 |
| Other areas at activities | 953 | 889 |
| **Total** | **11 927** | **10 129** |

| According to internal ratings | 31.12.2018 | 31.12.2017 |
|---|---|---|
| 5 low credit risk | 257 | 346 |
| 6 low credit risk | 1 799 | 3 722 |
| 7 medium credit risk | 6 055 | 3 938 |
| 8 medium credit risk | 1 622 | 374 |
| 9 heightened credit risk | 625 | 621 |
| 10 high credit risk | 187 | 84 |
| 11 high credit risk | 0 | 0 |
| 12 non-satisfactory rating | 21 | 16 |
| 13 non-satisfactory rating | 405 | 605 |
| Non-rated * | 956 | 423 |
| **Total** | **11 927** | **10 129** |

Performance guarantees are over-collateralised as at each reporting date. Therefore, the Group has not borne any losses from performance guarantee contracts neither in 2018 nor in previous period.

## NOTE 24 Transactions with related parties

In preparing the financial statements of the Group, the following entities have been considered related parties:

- owners that have significant impact on the Group and the entities related to them;
- members of the management board and legal entities controlled by them (together referred to as management);
- members of the supervisory board;
- close relatives of the persons mentioned above and the entities related to them.

| Transactions | Note | 2018 | 2017 |
|---|---|---|---|
| **Interest income** | 7 | **67** | **63** |
| incl. management | | 29 | 27 |
| incl. shareholders, their related entities and close relatives that have significant influence | | 38 | 36 |
| **Fee and commission income** | 8 | **11** | **8** |
| incl. management | | 2 | 2 |
| incl. shareholders, their related entities and close relatives that have significant influence | | 9 | 6 |
| **Interest expenses from deposits** | 7 | **42** | **41** |
| incl. management | | 2 | 1 |
| incl. shareholders, their related entities and close relatives that have significant influence | | 40 | 40 |
| **Interest expenses from subordinated debt** | 7 | **357** | **336** |
| incl. management | | 7 | 7 |
| incl. shareholders, their related entities and close relatives that have significant influence | | 350 | 329 |

| Balances | Note | 31.12.2018 | 31.12.2017 |
|---|---|---|---|
| **Loans and receivables as at the year-end** | | **3 328** | **2 820** |
| incl. management | 14 | 2 079 | 1 736 |
| incl. shareholders, their related entities and close relatives that have significant influence | 14 | 1 250 | 1 084 |
| **Deposits as at the year-end** | | **33 509** | **22 995** |
| incl. management | 17 | 222 | 283 |
| incl. shareholders, their related entities and close relatives that have significant influence | 17 | 33 287 | 22 712 |
| **Subordinated debt as at the year-end** | | **5 904** | **4 999** |
| incl. management | 20 | 135 | 104 |
| incl. shareholders, their related entities and close relatives that have significant influence | 20 | 5 769 | 4 895 |

The table provides an overview of the material balances and transactions involving related parties. All other transactions involving the close relatives and the entities related to members of the management board and supervisory board and the minority shareholders of the parent company AS LHV Group have occurred in the course and on the terms of ordinary business. There are no doubtful debts or provisions recorded for related parties.

Loans granted to related parties are issued at market conditions.

As at 31.12.2018 and 31.12.2017, the management did not have term deposits and the interest rate on demand deposits corresponds to the terms applicable to customers.

The subordinated debts received in November 2018 have the interest rate of 6.0%. The subordinated debts received in October 2015 have the interest rate of 6.5%. The subordinated debts received in June 2014 have the interest rate of 7.25%, refer to Note 20.

In 2018, salaries and other compensations paid to the management of the parent AS LHV Group and its subsidiaries totalled EUR 1 471 thousand (2017: EUR 1 371 thousand), including all taxes. As at 31.12.2018, remuneration for December and accrued holiday pay in the amount of EUR 91 thousand (31.12.2017: EUR 84 thousand) is reported as a payable to management (Note 18). The Group did not have any long-term payables or commitments to the members of the management board and the supervisory board as at 31.12.2018 and 31.12.2017 (pension liabilities, termination benefits, etc.). In 2018, the remuneration paid to the members of the Group's supervisory board totalled EUR 37 thousand (2017: EUR 39 thousand).

The Group has signed contracts with the members of the management board, which do not provide for severance benefits upon termination of the contract. In any matters not regulated by the contract, the parties adhere to the procedure specified in the legislation of the Republic of Estonia.

Management is involved with share option program. In 2018, the share options were granted to the members of the management board in the amount of EUR 497 thousand (2017: EUR 420 thousand).

Information on assets of related parties held as an account manager is presented in Note 22.

## NOTE 25 Basic earnings and diluted earnings per share

In order to calculate basic earnings per share, net profit attributable to owners of the parent has been divided by the weighted average number of shares issued.

| | 2018 | 2017 |
|---|---|---|
| Profit (incl. discontinued operations) attributable to owners of the parent (in thousands of euros) | 25 237 | 19 603 |
| Profit attributable to owners of the parent from continuing operations (in thousands of euros) | 21 913 | 17 676 |
| Weighted average number of shares (in thousands of units) | 25 892 | 25 562 |
| Basic earnings per share (EUR) | 0.97 | 0.77 |
| Basic earnings per share from continuing operations (EUR) | 0.85 | 0.69 |
| Basic earnings per share from discontinued operations (EUR) | 0.12 | 0.08 |
| Weighted average number of shares used for calculating the diluted earnings per shares (in thousands of units) | 26 373 | 26 049 |
| Diluted earnings per share (EUR) | 0.96 | 0.75 |
| Diluted earnings per share (EUR) from continuing operations | 0.83 | 0.68 |
| Diluted earnings per share (EUR) from discontinued operations | 0.13 | 0.07 |

| **Weighted average number of shares used as the denominator (in thousands of shares)** | **2018** | **2017** |
|---|---|---|
| Weighted average number of ordinary shares used as the denominator in calculating basic earnings per share | 25 892 | 25 562 |
| Adjustments for calculation of diluted earnings per share: | | |
| Share options | 481 | 488 |
| Weighted average number of ordinary shares and potential ordinary shares used as the denominator in calculating diluted earnings per share | 26 373 | 26 049 |

## NOTE 26 Discontinued operations

In Q1 2018 LHV was approached by Inbank with initiative to purchase UAB Mokilizingas shares from LHV. By that time Mokilizingas was not any more strategic investment for LHV as company was restructured and profitability increased. Still it required similar focus compared to much larger business lines.

On May 23, 2018 LHV and Inbank reached an agreement, according to which Inbank paid EUR 2.9 million for the 50%+1 share of UAB Mokilizingas. All loans to Mokilizingas were refinanced as well, partially covered with EUR 25 million short-term bridge loan from LHV Pank.

UAB Mokilizingas statement of financial position is disclosed in Note 6. The table below summarises the financial results of UAB Mokilizingas for 2017 and for the first 4 months of 2018 until disposal of the subsidiary.

| | 2018 | 2017 |
|---|---|---|
| Net interest income | 1 619 | 5 142 |
| Net fee and commission income | 956 | 1 190 |
| Personnel expenses | -535 | -1 673 |
| Operating expenses | -1 131 | -2 866 |
| Impairment losses on loans | -390 | 431 |
| Income tax expenses | -144 | -297 |
| **Subtotal** | **375** | **1 927** |
| Other financial income (gain on disposal) | 2 949 | 0 |
| **Profit from discontinued operations** | **3 324** | **1 927** |

| **Summarised statement of Financial Position** | **30.04.2018** | **31.12.2017** |
|---|---|---|
| Loans and advances to customers and other current assets | 67 477 | 53 915 |
| Non-current assets | 222 | 239 |
| Current liabilities | 6 897 | 8 727 |
| Non-current liabilities | 51 700 | 36 700 |
| **Total net assets** | **9 102** | **8 727** |

## NOTE 27 Separate primary financial statements of parent company

In accordance with the Estonian Accounting Act, information on the separate primary financial statements of the parent of the consolidation group shall be disclosed in the notes to the financial statements.

**Statement of profit or loss and other comprehensive income of the parent**

| *(in thousands of euros)* | 2018 | 2017 |
|---|---|---|
| Interest income | 1 530 | 1 530 |
| Interest expense | -2 231 | -2 136 |
| **Net interest expense** | **-701** | **-606** |
| | | |
| Dividends received | 6 578 | 3 803 |
| Net gains from investments to associates | 6 400 | 0 |
| **Net gains/losses from financial assets** | **12 978** | **3 803** |
| | | |
| Operating expenses | -666 | -471 |
| **Profit for the year** | **11 611** | **2 726** |
| | | |
| **Total profit and other comprehensive income for the year** | **11 611** | **2 726** |

**Statement of financial position of the parent**

| *(in thousands of euros)* | 31.12.2018 | 31.12.2017 |
|---|---|---|
| **Assets** | | |
| Due from banks and investment companies | 21 565 | 11 018 |
| Loans granted | 32 288 | 22 286 |
| Other receivables and assets | 75 | 6 |
| Investments in subsidiaries | 73 811 | 64 955 |
| **Total assets** | **127 739** | **98 265** |
| | | |
| **Liabilities** | | |
| Accrued expenses and other liabilities | 136 | 60 |
| Subordinated debt | 51 214 | 31 110 |
| **Total liabilities** | **51 350** | **31 170** |
| | | |
| **Equity** | | |
| Share capital | 26 016 | 25 767 |
| Share premium | 46 653 | 46 304 |
| Statutory reserve capital | 3 451 | 2 471 |
| Other reserves | 2 012 | 1 413 |
| Accumulated deficit | -1 744 | -8 860 |
| **Total shareholders' equity** | **76 388** | **67 095** |
| | | |
| **Total liabilities and equity** | **127 739** | **98 265** |

## Statement of cash flows of the parent

| *(in thousands of euros)* | 2018 | 2017 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Interest received | 1 530 | 1 530 |
| Interest paid | -2 231 | -2 136 |
| Administrative and other operating expenses paid | -583 | -441 |
| **Cash flows from operating activities before change in operating assets and liabilities** | **-1 284** | **-1 047** |
| | | |
| **Adjustments** | | |
| Investments in subsidiaries from share options | -1 156 | -938 |
| **Net increase/(decrease) in operating assets and liabilities:** | | |
| Net increase/(decrease) of other receivables | -74 | -2 |
| Net increase/(decrease) of other liabilities | 1 308 | 944 |
| Discontinued operations | 2 454 | 0 |
| **Net cash from/(used in) operating activities** | **1 248** | **-1 043** |
| | | |
| **Cash flows from investing activities** | | |
| Loans granted | -10 000 | 0 |
| Capital repayments from subsidiaries and associates | 1 200 | 6 600 |
| Capital contributions to subsidiaries and associates | -10 000 | -3 000 |
| Proceeds from disposal of subsidiary, net of cash received | 5 046 | 0 |
| **Net cash from/(used in) investing activities** | **-13 754** | **3 600** |
| | | |
| **Cash flows from financing activities** | | |
| Subordinated loans received | 20 000 | 0 |
| Paid in to share capital (incl. share premium) | 598 | 823 |
| Dividends received | 6 578 | 3 803 |
| Dividends paid | -4 123 | -3 803 |
| **Net cash from financing activities** | **23 053** | **823** |
| | | |
| **Increase/(decrease) in cash and cash equivalents** | **10 547** | **3 380** |
| Cash and cash equivalents at the beginning of the financial year | 11 018 | 7 638 |
| **Cash and cash equivalents at the end of the financial year** | **21 565** | **11 018** |

## Statement of changes in shareholders' equity

| *(in thousands of euros)* | Share capital | Share premium | Statutory reserve capital | Other reserves | Accumulated loss/retained earnings | Total |
|---|---|---|---|---|---|---|
| **Balance as at 01.01.2017** | **25 356** | **45 892** | **1 580** | **1 283** | **-7 720** | **66 391** |
| Paid in share capital | 411 | 412 | 0 | 0 | 0 | **823** |
| Dividends paid | 0 | 0 | 0 | 0 | -3 803 | **-3 803** |
| Transfer to statutory reserve capital | 0 | 0 | 891 | 0 | -891 | **0** |
| Share options | 0 | 0 | 0 | 130 | 827 | **957** |
| Total other comprehensive income for 2017 | 0 | 0 | 0 | 0 | 2 727 | **2 727** |
| **Balance as at 31.12.2017** | **25 767** | **46 304** | **2 471** | **1 413** | **-8 860** | **67 095** |
| Carrying amount of holdings under control and significant influence | 0 | 0 | 0 | 0 | -64 117 | **-64 117** |
| Value of holdings under control and significant influence under equity method | 0 | 0 | 0 | 36 | 117 048 | **117 084** |
| **Adjusted unconsolidated equity as at 31.12.2017** | **25 767** | **46 304** | **2 471** | **1 449** | **44 071** | **120 062** |
| **Balance as at 01.01.2018** | **25 767** | **46 304** | **2 471** | **1 413** | **-8 860** | **67 095** |
| Paid in share capital | 249 | 349 | 0 | 0 | 0 | **598** |
| Dividends paid | 0 | 0 | 0 | 0 | -4 123 | **-4 123** |
| Transfer to statutory reserve capital | 0 | 0 | 980 | 0 | -980 | **0** |
| Share options | 0 | 0 | 0 | 599 | 496 | **1 095** |
| Total other comprehensive income for 2018 | 0 | 0 | 0 | 0 | 11 611 | **11 611** |
| **Balance as at 31.12.2018** | **26 016** | **46 653** | **3 451** | **2 012** | **-1 856** | **76 276** |
| Carrying amount of holdings under control and significant influence | 0 | 0 | 0 | 0 | -72 859 | **-72 859** |
| Value of holdings under control and significant influence under equity method | 0 | 0 | 0 | 78 | 150 145 | **150 223** |
| **Adjusted unconsolidated equity as at 31.12.2018** | **26 016** | **46 653** | **3 451** | **2 090** | **75 430** | **153 640** |

Adjusted unconsolidated equity is the maximum amount that can be distributed to shareholders' according to Estonian legislation.

# Signatures of the management board to the consolidated annual report

The management board has prepared the management report and the consolidated financial statements of AS LHV Group for the financial year ended 31 December 2018.

The management board confirms that the management report on pages 4 to 48 provides a true and fair view of the business operations, financial results and financial condition of the parent company and the entities included in consolidation as a whole.

The management board confirms that according to their best knowledge the consolidated financial report on pages 49 to 146 presents a fair view of the assets, liabilities, financial position and profit or loss of the issuer and the entities involved in the consolidation as a whole according to the International Financial Reporting Standards as they are adopted by the European Union and contains a description of the main risks and doubts.

**18.02.2019**

**Madis Toomsalu**

# *Independent auditor's report*

## *To the Shareholders of AS LHV Group*

(Translation of the Estonian original)*

## *Report on the audit of the consolidated financial statements*

### *Our opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of AS LHV Group and its subsidiaries (together the Group) as at 31 December 2018, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the European Union.

Our opinion is consistent with our additional report to the Audit Committee.

### *What we have audited*

The Group's consolidated financial statements comprise:

- the consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 2018;
- the consolidated statement of financial position as at 31 December 2018;
- the consolidated statement of cash flows for the year then ended;
- the consolidated statement of changes in equity for the year then ended; and
- the notes to the consolidated financial statements, which include significant accounting policies and other explanatory information.

### *Basis for opinion*

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the consolidated financial statements section of our report.

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

### *Independence*

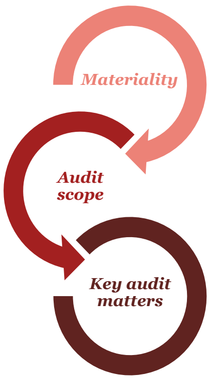
We are independent of the Group in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) and the ethical requirements of the Auditors Activities Act of the Republic of Estonia. We have fulfilled our other ethical responsibilities in accordance with the IESBA Code and the ethical requirements of the Auditors Activities Act of the Republic of Estonia.

To the best of our knowledge and belief, we declare that non-audit services that we have provided to the Group are in accordance with the applicable law and regulations in the Republic of Estonia and that we have not provided non-audit services that are prohibited under § $59^1$ of the Auditors Activities Act of the Republic of Estonia.

The non-audit services that we have provided to the Group, in the period from 1 January 2018 to 31 December 2018, are disclosed in the management report.

## Our audit approach

### Overview




*Materiality*

Overall group materiality is EUR 1,370 thousand, which represents 5% of profit before income tax.

*Audit scope*

A full scope audit was performed by PwC Estonia for all Group entities covering substantially all of the Group's consolidated assets, liabilities, revenues and expenses.

*Key audit matter*

Impairment of loans and advances to customers

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the consolidated financial statements. In particular, we considered where the Management Board made subjective judgments; for example, in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. As in all of our audits, we also addressed the risk of management override of internal controls, including among other matters, consideration of whether there was evidence of bias that represented a risk of material misstatement due to fraud.

### Materiality

The scope of our audit was influenced by our application of materiality. An audit is designed to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement. Misstatements may arise due to fraud or error. They are considered material if individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the consolidated financial statements.

Based on our professional judgment, we determined certain quantitative thresholds for materiality, including the overall group materiality for the consolidated financial statements as a whole as set out in the table below. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures and to evaluate the effect of misstatements, both individually and in aggregate on the financial statements as a whole.

| | |
|---|---|
| ***Overall group materiality*** | EUR 1,370 thousand |
| ***How we determined it*** | 5% of profit before income tax |
| ***Rationale for the materiality benchmark applied*** | We have applied this benchmark, as profit before tax is the key measure used both internally by management and, we believe, externally by shareholders in evaluating the performance of the Group. |

### *Key audit matters*

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

| *Key audit matter* | *How our audit addressed the key audit matter* |
|---|---|
| **Impairment of loans and advances to customers** (refer to Note 2 "Summary of significant accounting policies", Note 3.2 "Credit risk" and Note 13 "Loans and advances to customers" for further details)<br><br>As at 31 December 2018 loans and advances to customers amounted to EUR 918.8 million and related impairment loss for 2018 amounted to EUR 4.9 million.<br><br>We focused on this area because management makes complex and subjective judgments over both timing of recognition of impairment and the estimation of the size of any such impairment, using complex models with subjective inputs. Furthermore, due to implementation of IFRS 9 from 1 January 2018, the accounting policies and methods applied on impairment calculation have changed as compared to prior years.<br><br>IFRS 9 has introduced a 3-stage Expected Credit Loss (ECL) model. ECL calculations are forward-looking and probability-weighted, based on complex modelling and subjective inputs determined by the management. Key areas requiring significant management judgements and modelling in calculating ECL include:<br><br>• the criteria for assessment of significant increase in credit risk for corporate and retail products (Note 3.2.3.1) for determining loan exposures in stage 1 and stage 2;<br>• the modelling and calculation of key parameters of the ECL model, including | We assessed whether the Group's accounting policies and methodology applied for the calculation of impairment of loans and advances to customers are in compliance with IFRS 9.<br><br>We assessed the design and operating effectiveness of key controls over ECL data and respective calculations. This included controls over the allocation of assets into stages, data accuracy and completeness, credit monitoring and overdue loans monitoring. We have also assessed the IT general controls over relevant systems.<br><br>In addition, we tested the design and operating effectiveness of the credit file periodic review and rating assessment, and monitoring of collateral controls for corporate loans. We determined that we could rely on these controls for the purposes of our audit.<br><br>We performed detailed testing over:<br><br>• the completeness and accuracy of data used in the ECL calculation system;<br>• the compliance of key inputs used in the ECL calculation system with IFRS 9 methodology;<br>• the accuracy and compliance of 12-month and lifetime ECL calculations with IFRS 9 methodology;<br>• the accuracy of discounting in the ECL system;<br>• the accuracy and completeness of data used for staging of loans;<br>• the internal assignment of credit ratings for |

probability of default (PD), loss given default (LGD) and exposure at default (EAD) (Note 3.2.3.3);

- incorporating forward-looking information into ECL model and the indicators selected for corporate and retail products; estimating those indicators for reliable future period and for three different scenarios (base, upside and downside scenario) with different probabilities (Note 3.2.3.4); and
- ensuring completeness of the customer accounts that are included in the expected credit loss calculation.

For defaulted corporate loans, an individual impairment is calculated based on the exposure and realisable value of the collateral at the balance sheet date.

corporate loan customers, which serve as inputs into the corporate loan ECL model;

- the correctness of information on collaterals and their values in the loan systems, which serve as an input into the ECL model; and
- the completeness of loans subject to stage 3 assessment and related ECL calculations.

We have assessed the reasonableness of key assumptions made by management, which serve as critical inputs in the ECL model, such as weights of different scenarios, corporate portfolio point in time PD estimate, key forecasts of macroeconomic information and multipliers used for different scenarios.

We performed analytical procedures to evaluate the ECL of different products through the year.

We have audited the results of back-testing performed by management and agree with their assessment that the impairment provisions have been adequate, in all material respects, in the prior period.

In case of some impairment provisions, we formed a different view from that of the management, but the differences were within a reasonable range of outcomes in the context of the overall loans and advances and the uncertainties disclosed in the financial statements.

As a result of our work, we noted no material exceptions.

### *How we tailored our audit scope*

We tailored the scope of our audit in order to perform sufficient work to enable us to provide an opinion on the consolidated financial statements as a whole, taking into account the structure of the Group, the accounting processes and controls, and the industry in which the Group operates.

After the disposal of Lithuanian subsidiary in 2018, the remaining Group subsidiaries mostly operate in Estonia. A full scope audit was performed by us for the following Group entities covering substantially all of the Group's consolidated statements of financial position and profit or loss:

- AS LHV Group;
- AS LHV Pank, including its branch in the UK and subsidiary AS LHV Finance; and
- AS LHV Varahaldus.

## Other information

The Management Board is responsible for the other information contained in the consolidated annual report in addition to the consolidated financial statements and our auditor's report thereon.

Our opinion on the consolidated financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

## Responsibilities of the Management Board and those charged with governance for the consolidated financial statements

The Management Board is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the European Union, and for such internal control as the Management Board determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, the Management Board is responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the Management Board either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Group's financial reporting process.

## Auditor's responsibilities for the audit of the consolidated financial statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit 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 Group's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the Management Board.
- Conclude on the appropriateness of the Management Board's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the Group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

## *Report on other legal and regulatory requirements*

### *Appointment and period of our audit engagement*

We were first appointed as auditors of AS LHV Group, as a public interest entity, for the financial year ended 31 December 2009. Our appointment has been renewed by tenders and shareholder resolutions in the intermediate years, representing the total period of our uninterrupted engagement appointment for AS LHV Group, as a public interest entity, of 10 years. In accordance with the Auditors Activities Act of the Republic of Estonia and the Regulation (EU) No 537/2014, our appointment as the auditor of AS LHV Group can be extended for up to the financial year ending 31 December 2028.

AS PricewaterhouseCoopers

Ago Vilu
Certified auditor in charge, auditor's certificate no.325

Verner Uibo
Auditor's certificate no.568

19 February 2019

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

# Proposal for profit distribution

The management board of LHV Group proposes to the General Meeting of Shareholders to distribute the profit of the financial year 2018 as follows:

- transfer EUR 1 262 thousand to statutory reserve capital;
- pay dividends EUR 0.21 per share in the total amount of EUR 5 463 thousand; related income tax would be EUR 1 245 thousand;
- transfer the profit for reporting period attributable to shareholders of the parent in the amount of EUR 18 512 thousand to retained earnings.

# Signatures of the supervisory board to the annual report

The supervisory board has reviewed the annual report which consists of the management report and the financial statements, the independent auditor's report and the profit distribution proposal, and approved it for presentation at the general meeting of shareholders.

18.02.2019

Chairman of the supervisory board:

**Rain Lõhmus**

Members of the supervisory board:

**Raivo Hein**

**Tiina Mõis**

**Tauno Tats**

**Heldur Meerits**

**Sten Tamkivi**

**Andres Viisemann**

# Allocation of income according to EMTA classificators

**Consolidated:**

| EMTAK | Activity | 2018 | 2017 |
|---|---|---|---|
| 66121 | Security and commodity contracts brokerage | 5 111 | 4 010 |
| 64191 | Credit institutions (banks) (granting loans) | 56 974 | 49 091 |
| 64911 | Finance lease | 2 439 | 1 845 |
| 66301 | Fund management | 13 942 | 13 293 |
| | **Total income** | **78 466** | **68 239** |

**Unconsolidated:**

| EMTAK | Activity | 2018 | 2017 |
|---|---|---|---|
| 64201 | Activities of holding companies | 1 530 | 1 530 |
| | **Total income** | **1 530** | **1 530** |