

Basel II

Pillar 3 - Disclosures

2010

1. Overview

1.1 Background

The international capital adequacy standards set forth by the Basel Committee on Banking Supervision, known as Basel II, are structured around three pillars: Pillar 1 (the minimum capital requirements), Pillar 2 (supervisory review) and Pillar 3 (market discipline). The Pillar 3 complements the other two pillars and requires firm to distil information to market participants. Financial institutions are required to provide updated information regularly on the implementation of the Basel II framework and risk management processes in accordance with the regulatory requirement. In the UK, this is set out in BIPRU 11 and supervised by the FSA.

1.2 Basis and Frequency of Disclosures

Bank of China (UK) Ltd (“BOC UK” or “the Bank”) has been Basel compliant since 2008 and has operated under the international capital adequacy standards set forth by Basel II. The purpose of this document is to disclose information about the risk inherit in BOC UK’s business, the structure and procedures that the Board of Directors (“the Board”) have established to manage those risks. It also provides information about the Bank’s capital structure and capital adequacy.

The Bank aims to make disclosure on an annual basis as soon as practicable after the publication of the Annual Report and Accounts.

1.3 Scope of application

BOC UK is a bank offering retail, corporate, and trade finance services in the UK. BOC UK is a wholly owned subsidiary of Bank of China Limited (“BOC China”), located in Beijing, China and listed on Hong Kong and Shanghai Stock Exchange. BOC UK is authorised and regulated by the FSA. The Bank has the following subsidiaries:

- China Visa Services Limited – a wholly owned, non-banking subsidiary in UK with offices in London and Manchester; and wholly owned subsidiaries in Milan, Italy and Jakarta, Indonesia.
- Bank of China (Suisse) S.A. (“BOCS”) – a wholly owned private banking subsidiary in Geneva, Switzerland. BOCS is regulated by the Swiss Financial Market Supervisory Authority (FINMA).

1.4 Principles of Consolidation

For accounting purposes, the Bank has availed itself of the exemption available under IAS27 “Consolidated and Separate Financial Statements” that permits an entity to prepare separate financial statements (refer to note 2 of BOC UK’s Annual Report and Accounts for the period ended 31 December 2010) and therefore has not consolidated these subsidiaries.

The Bank does not foresee any material practical or legal impediments to the prompt transfer of capital resources or repayment of liabilities among the parent undertaking and its subsidiaries.

2. Risk Management Objectives and Policies

2.1 Risk Appetite

The Board, representing the interests of the Bank’s shareholders, has the ultimate responsibility for risk management and the setting of the Bank’s risk appetite. Risk appetite is communicated by the Bank’s executive management to the various business divisions through the implementation of the Bank’s strategic plans. The Bank’s risk appetite is deemed to be conservative.

BOC UK credit risk appetite is conservative, set in line with the approach deemed appropriate by the shareholders and the Board of Directors of BOC UK.

The conservative risk appetite is reflected in targeting of investment grade counterparties as well as limited holding of high leverage, development and project finance in Corporate Banking business. Consideration may be given to asset backed financing, e.g. commercial property, aircraft etc. In addition, business is carefully controlled within certain range of RAROC, synchronised with current market condition.

In Retail Banking business, the bank focuses on collateralised mortgage lending for residential property. There is a small credit card business within which each name is separately risk assessed. Unsecured personal lending is not part of the bank’s product range.

For Market Risk, the Value at Risk (“VAR”) and Price Value of a Basis Point (“PVBP”) limits are set out in the Market Risk Policy to reflect the risk appetite.

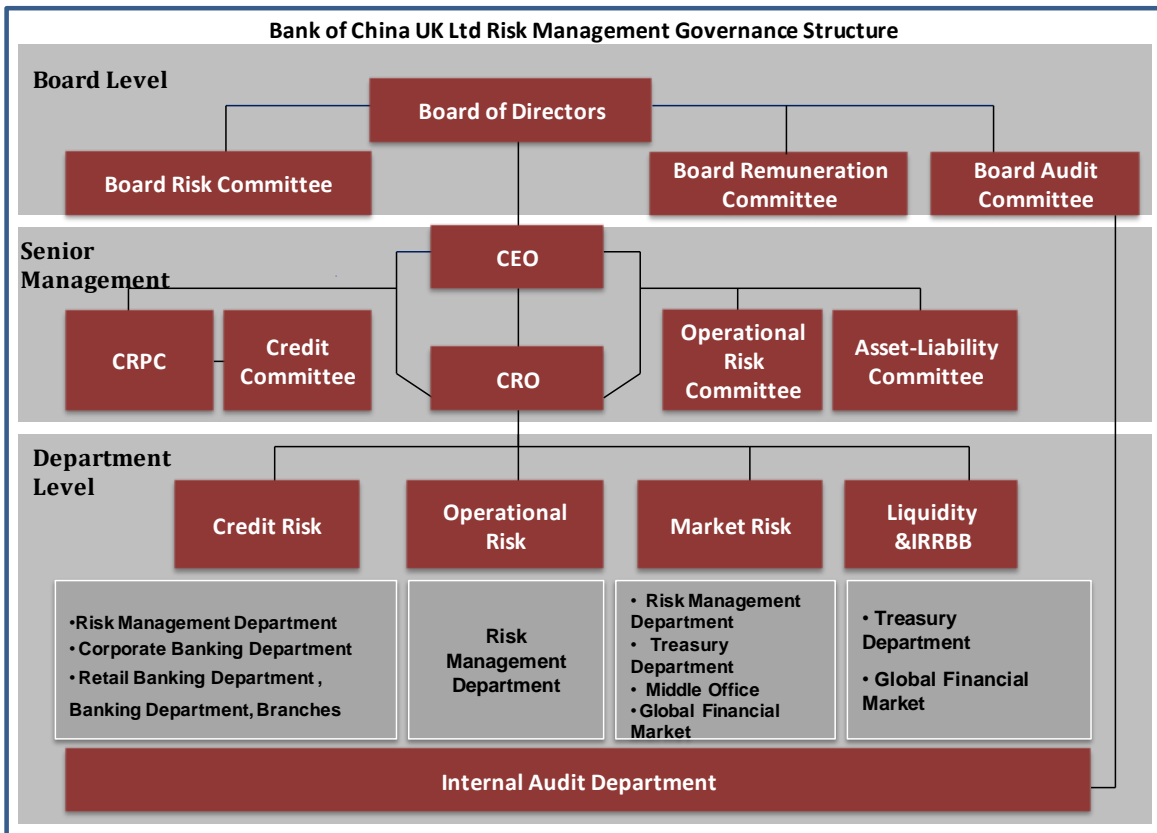
2.2 Risk Management Objectives

The objective of the Bank’s risk management governance structure is to ensure that risks material to the Bank are adequately managed and controlled within of the Bank’s risk tolerance.

The principal risks facing the Bank are Credit Risk, Operational Risk, Market Risk, Liquidity Risk, Banking Book Interest Rate Risk, Concentration Risk and Strategic Risk.

2.3 Risk Management Structure

The composition of the Bank’s risk management governance structure and the reporting lines can be seen in the following illustrations:



- **Board of Directors** – is the primary governing body of the Bank, which proves the Bank’s risk appetite and risk management framework.
- **Board Audit Committee** – performs an oversight role over internal controls, risk management, financial reporting issues and external auditor liaison.
- **Board Risk Committee (“BRC”)** – approves all non-standard credits, assists the Board with the establishment and ongoing review of the Bank’s credit policy statement and approval of delegated authorities over limits.
- **CEO** - who reports to the Board, is responsible for the implementation of policies and procedures in accordance with the risk management strategies and risk appetite set by the Board. The CEO also oversees operating effectiveness of the processes and controls and monitors risks of daily business operations.
- **Credit Risk Policy Committee (“CRPC”)** – Establishes and review the Bank’s credit policy statement and procedures.
- **Credit Committee (“CC”)** – The CC is the credit body comprised of nominated members from management and departments. It recommends or veto credit proposals submitted by business departments and branches at regular CC meetings on a voting basis. The detailed responsibilities are listed in TOR of CC.

- **Operational Risk Committee (“ORC”)** – review and management of the Bank’s operational risk; legal risk and reputational risk. It is also responsible for maintenance of the Bank’s operational risk monitoring framework and operational risk compliance.
- **Asset-Liabilities Management Committee (“ALCO”)** – establishes and maintains asset and liability management policies and procedures, including the review and approval of policies relating to market risk and liquidity risk management.
- **Chief Risk Officer (“CRO”)** – with direct reporting line to the Bank’s CEO, is responsible for the monitoring and control of credit, market and operational risks. The CRO is also responsible for providing recommendations to the policies and procedures over the management of those risks.

The Bank has adopted a “Three Lines of Defence” model in its risk management framework. Primary responsibility for the identification, management, monitoring and mitigation of risks lies with the respective business divisions, which are the Bank’s first line of defence.

The Bank’s second line of defence is provided through the Compliance function and the following functions and committees, which are responsible for the Bank’s risk governance and oversight:

- Specialist risk support functions (i.e. Credit Risk Management, Operational Risk Management, Market Risk Management and Liquidity Risk Management functions);
- Dedicated Risk Committees (i.e. the “CRPC”, “CC”, “ORC” and “ALCO”);
- Executive Management Committee (“EMC”); and
- Board Risk Committee (“BRC”, formerly the Board Credit Committee).

The Bank’s third line of defence, the independent assurance, is provided by the Bank’s Internal Audit Department and the Board Audit Committee.

3. Capital Resources

Total Capital Resource		
	31 December 2010	31 December 2009
	£000	£000
Tier 1 Capital		
Share Capital	140,000	140,000
Profit and loss reserve	26,598	15,819
Tier 2 Capital		
Subordinated debt	60,000	60,000
Less: Investments in subsidiaries	(94,357)	(29,945)
Total Tier 1 and 2 capital after deductions	132,241	185,874

The Bank's **Tier 1 capital** consists of ordinary share capital and profit and loss reserves. The profit and loss reserves represent the Bank's audited accumulated accounting profits.

The Bank currently has no innovative Tier 1 instruments. As at 31 December 2010, there is no reconciliation differences between the amounts disclosed as Tier 1 capital to those treated as equity under IFRS.

The Bank's **Tier 2 capital** includes qualifying subordinated debt.

The subordinated debt is issued on terms which qualify for inclusion in the Bank's capital resources. Information on the terms of the subordinated debt is included in *note 29* of the Bank's *Annual Report and Financial Statements for the year ended 31 December 2010*.

The Bank does not hold any **Tier 3 capital**.

4 Capital Adequacy

4.1 Capital Management

The capital planning and management framework is in place to facilitate a top-down approach to the management of the Bank's capital supply and capital usage. A forward looking capital planning process is conducted via a detailed planning of business and risk forecasts, stress and business scenarios and management actions to determine the impact of potential economic scenarios. This enables the Bank to manage its capital requirements, both current and projected (using base and stressed cases), by forecasting capital adequacy ratios and updating them in line with the business performance and any changes in the business environment.

4.2 Internal Capital Adequacy Assessment Process ("ICAAP")

The Bank undertakes the ICAAP, which is an internal assessment of the Bank's risk profile and its capital needs on an annual basis. The outcome of the ICAAP is presented in an Internal Capital Assessment ("ICA") document. The Bank's ICA includes an analysis of the Bank's material risk exposures in the determination of the capital requirement over a three-year horizon, including the impact of stressed scenarios to satisfy the regulatory requirements. The FSA, under its supervisory approach, sets Individual Capital Guidance ("ICG") for the Bank. The Bank submitted its first ICA document to the FSA in October 2008 and the ICG was agreed with the FSA in March 2009.

4.3 Pillar 1 Minimum Capital Requirement

Credit Risk

The Bank's minimum capital requirement of credit risk is expressed as 8% of the risk weighted exposure amounts for each of the applicable standardised credit risk exposure classes.

Minimum Capital Requirement for Credit Risk by Exposure Classes under the Standardized Approach

	As at 31 December 2010		As at 31 December 2009	
	RWA	Capital Requirement	RWA	Capital Requirement
£000				
Central governments or central banks	37	3	22	2
Institutions	44,471	3,558	74,476	5,958
Corporates	250,515	20,041	519,292	41,543
Retail	33,834	2,707	21,831	1,746
Secured on real estate property	1,570	126	1,291	103
Past due items	74	6	37	3
Securitization positions	8,944	716	12,326	986
Short term claims on institutions and corporates	14,477	1,158	108,633	8,691
Other items	48,059	3,845	31,241	2,499
Total	401,981	32,158	769,149	61,531

Market risk

The market risk capital requirement is calculated using the standard Position Risk Requirement rules (“PRR”). The only market risk requirement is the foreign exchange PRR. Please refer to section 6 for a full analysis of market risk.

Operational risk

The operational risk capital requirement is calculated on a Basic Indicator Approach (“BIA”) approach, which amounts to £4,550,000. Please refer to section 7 for a full analysis of operational risk.

Capital Adequacy Regarding Pillar 1 Capital Requirement

	31 December 2010 £000	31 December 2009 £000
Credit Risk (Standardised Approach)	32,158	61,531
Market Risk (Foreign Exchange PRR)	404	411
Operational Risk (“BIA”)	4,550	2,891
Total Pillar 1 minimum capital requirement	37,112	64,833
Total capital resources	132,241	185,874
Excess of capital resources over Pillar 1 minimum capital requirement	95,129	121,041

5 Credit Risk Measurement, Mitigation and Reporting

5.1 Credit Risk Management and Controls

There are three levels in the Bank's credit risk control process.

The **first level** is the initial credit assessment process, where credit reports / business proposals are prepared by the relevant business divisions

These credit reports / business proposals are submitted to the respective Risk Management team within RMD for the **second level review**. RMD performs a credit risk assessment on the business proposals submitted by the respective business divisions. The results of RMD's risk assessment process, together with the original business proposals, are forwarded either to the approvers (depending on the materiality of the business proposal and the related credit risk exposures) or are presented for discussion in the open forum of the CC meeting.

The **third level review** is applied where recommendations of the CC are presented to the ultimate sanctioning authority (i.e. the CRO/CEO and / or the Board) for approval and sign off.

5.2 Credit Risk Exposures

Gross Credit Exposure under the Standardised Approach

£000	2010		2009	
	Average Credit Exposure	End of Year Exposure	Average Credit Exposure	End of Year Exposure
Central governments or central banks	17	37	2,511	22
Institutions	140,609	110,473	546,048	582,909
Corporates	484,759	291,154	196,314	179,580
Retail	68,576	82,193	37,216	46,350
Secured on real estate property	1,624	1,623	1,064	1,347
Past due items	594	437	557	210
Securitisation positions	55,220	47,622	67,657	64,379
Short term claims on institutions and corporates	223,332	211,588	227,469	231,043
Other items	38,514	49,510	25,375	32,078
Grand Total	1,013,245	794,638	1,104,211	1,137,918

Geographic Distribution of Credit Exposure

£000	UK	Other European Countries	North America	Rest of the World	Total
2010					
Central governments or central banks	18	-	-	19	37
Corporates	243,500	80	7	47,567	291,154
Institutions	37,565	13,289	272	59,348	110,473
Retail	67,612	1,301	-	13,281	82,193
Secured on real estate property	1,411	-	-	211	1,623
Past due items	437	-	-	1	437
Securitisation positions	32,893	-	-	14,728	47,622
Short term claims on institutions and corporates	211,588	-	-	-	211,588
Other items	49,408	102	-	-	49,510
Grand Total	644,433	14,772	278	135,155	794,638
2009					
Central governments or central banks	-	-	-	22	22
Corporates	179,184	168,008	47,790	187,927	582,909
Institutions	43,569	46,914	58,874	30,223	179,580
Retail	44,588	107	-	1,655	46,350
Secured on real estate property	1,347	-	-	-	1,347
Past due items	210	-	-	-	210
Securitisation positions	23,735	35,545	-	5,099	64,379
Short term claims on institutions and corporates	127,750	19,588	-	83,705	231,043
Other items	31,904	-	174	-	32,078
Grand Total	452,287	270,162	106,838	308,631	1,137,918

Remaining Contractual Maturity of Credit Exposure

£000	Up to 12 months	1-5 yreas	More than 5 years	Total
2010				
Central governments or central banks	-	37	-	37
Corporates	7,132	198,360	85,662	291,154
Institutions	-	86,443	24,030	110,473
Retail	-	378	81,816	82,193
Secured on real estate property	-	0	1,623	1,623
Past due items	-	437	-	437
Securitisation positions	-	249	47,373	47,622
Short term claims on intitutions and corporates	179,590	31,998	-	211,588
Other items	-	49,510	-	49,510
Grand Total	186,722	367,412	240,503	794,638
2009				
Central governments or central banks	-	22	-	22
Corporates	245,128	331,064	6,717	582,909
Institutions	32,395	123,386	23,799	179,580
Retail	36	2,946	43,368	46,350
Secured on real estate property	-	154	1,194	1,347
Past due items	-	210	-	210
Securitisation positions	-	1,609	62,770	64,379
Short term claims on institutions and corporates	219,765	11,278	-	231,043
Other items	-	32,078	-	32,078
Grand Total	497,324,336	502,745,621	137,847,685	1,137,917,642

Industry Distribution of Gross Credit Exposure 2010

Exposure Class	Industry Category	Gross Exposure
		£000
Central governments or central banks	Business and other services	37
Institutions	Financial	110,473
Corporates	Business and other services	78,464
	Construction	308
	Energy and water supply industries	56,470
	Financial	11,950
	Garages, distribution, hotels and catering	2,224
	Manufacturing industry	111,597
	Postal services & telecommunication	17,472
	Transport	12,668
Retail	Business and other services	50
	Garages, distribution, hotels and catering	1,964
	Persons	80,180
Secured on real estate property	Business and other services	1,376
	Garages, distribution, hotels and catering	211
	Transport	36
Past due items	Garages, distribution, hotels and catering	385
	Persons	52
Securitisation positions	Financial	47,622
Short term claims on institutions and corporates	Financial	211,588
Other items	Business and other services	49,149
	Financial	360
Grand Total		794,638

Industry Distribution of Gross Credit Exposure 2009		Gross Exposure
Exposure Class	Industry	£000
Central governments or central banks	Business and other services	22
Institutions	Financial	179,580
Corporates	Business and other services	92,214
	Construction	18,376
	Energy and water supply industries	105,906
	Financial	25,160
	Garages, distribution, hotels and catering	60,147
	Manufacturing industry	208,898
	Postal services & telecommunication	63,620
	Transport	8,588
Retail	Business and other services	329
	Construction	7
	Energy and water supply industries	5
	Financial	13
	Garages, distribution, hotels and catering	1,568
	Manufacturing industry	17
	Persons	44,392
	Postal services & telecommunication	6
	Transport	13
Secured on real estate property	Business and other services	1,078
	Garages, distribution, hotels and catering	226
	Transport	43
Past due items	Garages, distribution, hotels and catering	162
	Persons	48
Securitisation positions	Financial	64,379
Short term claims on institutions and corporates	Business and other services	7,304
	Construction	13,650
	Energy and water supply industries	12,576
	Financial	133,662
	Garages, distribution, hotels and catering	411
	Manufacturing industry	63,440
Other items	Business and other services	32,078
Grand Total		1,137,918

5.3 Impairment Provisions

Identification of impairment lies in the responsibility of respective business department (Retail branch managers and the Corporate Banking Department). All potential impairments are risk assessed by the appropriate departments for recovery action, reclassification and provisioning. Such assessments are then evaluated and authorised by RMD. For more information regarding the measurement of impairment and provision methodology, please refer to the Bank's annual report.

The following table shows the past due and provisions for impaired exposures and charges to the income statement for the period ended 31 December 2010. For the purpose of this table, past due is defined as a minimum of one month.

£000	UK			Rest of the World		
	Impaired	Provision	Past due	Impaired	Provision	Past due
<i>as at 2010</i>						
Persons	(6)	31	(1,505)	-	1	(948)
Transport	-	-	(5)	-	-	-
Garages, distribution, hotels & catering	-	-	(110)	-	19	(14)
Grand Total	(6)	31	(1,621)	-	20	(961)
<i>as at 2009</i>						
Persons	(516)	516	(145)	-	-	-
Energy & Water supply industries	(15)	15	(1,223)	-	-	-
Garages, distribution, hotels & catering	(566)	181	-	(11,515)	5,403	-
Grand Total	(1,097)	712	(1,368)	(11,515)	5,403	-

Assets accounted for at amortised cost

If there is objective evidence that an impairment loss has been incurred, an allowance is established. For the Bank's lending portfolios, allowances are established on a case-by-case basis. 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 borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

A loan or advance is normally written-off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery (as a result of the customer's insolvency, ceasing to trade or other reason) and the amount of the loss has been determined. Subsequent recoveries of amounts previously written-off decrease the amount of impairment losses recorded in the income statement.

(a) Loans and advances to banks and customers

£000	Specific Loans and advances		Collective Loans and Advances	
	to banks	to customers	to banks	to customers
Balance as at 1 Jan 2010	-	531	-	-
Transfers	-	-	-	-
Increase in impairment	-	37	-	-
Reversal of impairment	-	(152)	-	-
Charge/ (Credit) in income statement	-	(115)	-	-
Amounts written off	-	(8)	-	-
Balance as at 31 Dec 2010	-	408	-	-
Balance as at 1 Jan 2009	-	378	-	24
Transfers	-	-	-	-
Increase in impairment	-	5,488	-	-
Reversal of impairment	-	(431)	-	(24)
Charge/ (Credit) in income statement	-	5,057	-	(24)
Amounts written off	-	(4904)	-	-
Balance as at 31 Dec 2009	-	531	-	-

Available-for-sale financial assets

For financial assets classified as available-for-sale a significant or prolonged decline in the fair value of the asset below its cost is considered to be objective evidence of impairment, when reviewing the current financial circumstances (including creditworthiness) and future prospects of the issuer and assessing the future cash flows expected to be realised.

If an impairment loss has been incurred, the cumulative loss is measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised. The cumulative loss is then removed from equity and recognised in the income statement.

If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income statement.

However, impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

(b) Available for sale financial investments

£000	Movement in fair value recognized in equity	Impairment
Balance as at 1 Jan 2010	5,819	5,584
Charges	(4,329)	150
Allocated as impaired	(150)	-
Write-offs	-	-
Exchange-rate movements	-	15
Balance as at 31 Dec 2010	1,341	5,748
Balance as at 1 Jan 2009	25,269	9,330
Recoveries	-	-
Recoveries	(22,656)	(3,206)
Allocated as impaired	3,206	-
Write-offs	-	-
Exchange-rate movements	-	(540)
Balance as at 31 Dec 2009	5,819	5,584

(c) Impairment Charges

£000	as at 31 Dec 2010	as at 31 Dec 2009
Loans and advances		
Specific	(115)	5,057
Collective	-	(24)
Available for sale financial investments	150	(3,206)
Grand Total	35	1,827

Renegotiated loans

Loans that are either subject to collective impairment assessment or individually significant and whose terms have been renegotiated are no longer considered to be past due but are treated as new loans. In subsequent years, the asset is considered to be past due and disclosed only if further renegotiated.

The Bank has not renegotiated any loans during the course of the financial period ended 31 December 2010.

5.4 Retail Credit Risk

Retail lending activity is split between secured products (prime and specialist lending) and unsecured products (credit cards and temporary overdrafts). Retail credit risks are managed in accordance with limits set out within the policy approved by CRPC. For residential mortgages, all mortgages are secured by way of a first legal charge against the property.

Ongoing monitoring of all retail credit portfolios is undertaken by the Retail Risk Team within RMD. In the event that particular exposures show adverse features such as arrears, a debt recovering team will be appointed to work with borrowers to resolve the situation.

5.5 Corporate Credit Risk

The Bank's corporate financing activity includes syndication loan, bilateral lending, debt securities and trade finance business. Corporate credit risks are managed in accordance with limits and asset quality measures stipulated in the policy approved by the CRPC. The policy specifies large exposure limits as well as industry and country risk exposures limits.

Corporate banking business proposal are examined by Corporate Risk Team in RMD. The credit quality of the borrower is assessed against established criteria. All borrowers are reviewed at least annually.

5.6 Financial Institutions Credit Risk

FI credit risk arises from due from, placement with, loan to, debt securities and trading with banks and other financial institutions.

FI credit risks are managed in accordance with limits as set out within the policy approved by the CRPC.

The ongoing monitoring of the quality of assets is performed by the Global Financial Market and Middle Office. Reports are sent on a monthly basis to senior management.

5.7 Credit Quality Step (“CQS”) Analysis

In its assessment of credit risk under the Standardised Approach, the Bank uses ratings assigned by the FSA’s recognised External Credit Assessment Institutions (“ECAIs”), e.g. Standard and Poor’s (“S&P”) and Moody’s Investors Service (“Moody’s”) for all its exposure classes. The Bank has not used any export credit agencies. Where rating is not available; the Bank follows the provision of the BIPRU.

Exposure values for each of the standardised credit risk exposure classes associated with each credit quality step prescribed in BIPRU 3 as at 31 December 2010:

	Risk weight	Moody's ratings	S&P ratings	Exposure values	RWA
CQS for Central governments or central banks					
Unrated	100%			37	37
Total				37	37
CQS for Corporates					
1	20%	Aaa to Aa3	AAA to AA-	12,403	2,481
2	50%	A1 to A3	A+ to A-	43,891	24,632
3	100%	Baa1 to Baa3	BBB+ to BBB-	61,666	61,666
4	100%	Ba1 to Ba3	BB+ to BB-	3,367	3,367
5	150%	B1 to B3	B+ to B-	16,515	24,773
Unrated				153,313	133,598
Total				291,154	250,515
CQS for Institutions					
1	20%	Aaa to Aa3	AAA to AA-	25,823	5,165
2	50%	A1 to A3	A+ to A-	57,502	28,751
3	50%	Baa1 to Baa3	BBB+ to BBB-	12,824	6,412
4	100%	Ba1 to Ba3	BB+ to BB-		
5	100%	B1 to B3	B+ to B-		
Unrated				14,324	4,143
Total				110,473	44,471
CQS for Short term claims on institutions and corporates					
Unrated				211,588	14,477
Total				211,588	14,477
CQS for Securitisation positions					
1	20%	Aaa to Aa3	AAA to AA-	35,444	6,508
Unrated				12,178	2,436
Total				47,622	8,944
Retail					
				82,193	33,834
Secured on real estate property					
				1,623	1,570
Past due items					
				437	74
Other items					
				49,510	48,059
Grand Total				794,638	401,981

Note:

1. Exposure value is the amount after applying credit conversion factors to off balance sheet exposures in accordance with the FSA regulatory rules.

5.8 Credit Risk Mitigation

The Bank has adopted the following risk mitigation techniques:

Netting agreement

The Bank has entered into a legal netting agreement with its parent company. The Bank ensures that documentation for such agreement is robust and has obtained opinions from external counsel that such documentation is legally enforceable in all relevant jurisdictions.

The International Swaps and Derivatives Association (“ISDA”) Master Agreement is the Bank’s preferred method of documenting derivative activity.

Guarantees

Collateral may also be taken in the form of guarantees given by individuals, corporate or financial institutions associated with the obligor counterparty. This type of guarantee or mitigation is not recognised for regulatory capital purpose. Cash collateral is held on terms which ensure that the cash cannot be paid away before the maturity of the secured exposure.

Collateral

Residential mortgages

Residential property is the Bank’s main source of collateral as means of mitigating credit risk inherent in the residential mortgage portfolios. All mortgage lending activities are supported by an appropriate form of valuation using either an independent firm of valuers or indexed valuation.

All residential property must be insured to cover property risks, which may be through a third party.

Commercial mortgages and Buy-to-Let

For property-based lending, supporting information such as professional valuations are an important tool to help determine the suitability of the property offered as security and, in the case of investment lending, generating the cash to cover interest and repay the advance. All valuations are undertaken by members of an internally approved panel of valuers.

All standard documentation is subject to independent legal review and sign-off in order to ensure that the Bank’s legal documentation is robust and enforceable. Documentation for large advances is tailor-made, specifically prepared by independent solicitors.

5.9 Counterparty Credit Risk (“CCR”)

The Bank uses derivative instruments to hedge its exposure to market risk, for example, interest rate risk in the banking book and foreign exchange risk. Counterparty credit risk is the risk that a counterparty to a derivative instrument could default prior to the maturity of the contract. The counterparty credit risk for derivative and foreign exchange instruments is subject to credit limits on the same basis as the Bank’s other credit exposures (see section 5.1 for further details).

The Bank measures its counterparty credit exposure using the CCR mark-to-market method, which is the sum of current exposure (i.e. replacement cost) and potential future exposure. The potential future exposure is an estimate based on factors such as the residual maturity of the contracts and the types of contract.

The Bank has not received nor provided collateral in respect of derivative contracts. Therefore, no collateral would need to be provided in the event of a downgrade in the Bank’s credit rating. The Bank only entered into derivative contracts with its group companies.

The Bank may also take advantage of the netting benefits afforded under the ISDA Master Agreement so that risk can be mitigated by offsetting the amounts due to the same counterparties. However during the financial period ended 31 December 2010, the Bank has not applied any netting benefits under the ISDA Master Agreement.

Counterparty credit exposures for derivative contracts as at 31 December 2010

£000	2010		2009	
	Assets	Liabilities	Assets	Liabilities
Interest rate swap	477	5,375	746	5,662
Cross currency swap	28	581	627	104
Foreign exchange forward	-	-	2	-
	505	5,956	1,375	5,766

5.10 Securitisation

The Bank is only involved as an investor in Asset Backed Securities (“ABS”), which sub-divided into automobile receivables and mortgage-backed securities.

The Bank adopted the Standardised approach to calculate its risk weighted exposure amounts of its investments in ABS. As at 31st December 2010, the Bank’s exposure to ABS is £46,303,121 (of which £43,259,398 relates to residential mortgage and £3,043,723 relates to Auto receivables).

The Bank uses ratings assigned by S&P and Moody’s for purposes of the calculation of its credit risk capital requirement under BIPRU 9. The above ABS assets are classified as available-for-sale for accounting purposes.

6 Market Risks and Interest Rate Risk on Banking Book (IRRBB)

The overall market risk limits are set by the Bank's EMC and allocated to the respective banking book. The Bank's Treasury Middle Office is responsible for the daily monitoring of the Bank's market risk

The Bank does not undertake any proprietary trading book activities. Any matched principal broking position is back to back squared. The Bank's market risk exposures relate mainly to foreign exchange risk exposure.

6.1 Foreign Exchange Risk

A proportion of treasury funding and investment activity is undertaken in foreign currencies. Foreign currency exposure is hedged by using derivatives to reduce currency exposures to acceptable levels. The Bank has no substantial net exposure to foreign exchange risks.

The Bank's foreign exchange positions as at 31 December 2010 are set out below:

Total net exposure £000	US Dollar	Euro	HK Dollars	YEN	Other
2010	3,517	979	-502	-1,645	-282
2009	2,874	1,832	-655	223	63

6.2 Interest Rate Risk in Banking Book ("IRRBB")

The Bank has banking book interest rate risk exposure and the risk management objective is to decrease the sensitivity of the Bank's earnings and economic value exposure to interest rate fluctuations.

The sources of interest rate risk include re-pricing risk, yield curve risk, basis risk and embedded option risk. The Bank at the moment mainly utilises the interest rate sensitivity gap to analyse the re-pricing risk on a static basis from both the net interest income and economic value perspectives. Interest rate-sensitive liabilities in each time band are subtracted from the corresponding interest rate-sensitive assets to produce a re-pricing gap for that time band.

The Bank sets a limit for its 1 year cumulative gap ratio (i.e. cumulative gap divided by interest-bearing assets) for all currencies expressed in sterling. The limit ranges from -15% to +15%. The 1 year cumulative gap ratio as at 31 December 2010 is 3.92% which is within the defined limit.

Impact of 100 bps parallel shift on projected net interest income

£000	100 bps increase	100 bps decrease
2010	1,750	(1,750)
2009	727	(727)

IRRBB Management

The ALCO, Treasury Department and the Global Financial Market Department are involved in the management of interest rate risk in the banking book. Interest rate risk is managed base on the contractual maturity of the underlying investments. There are no assumptions made on loan prepayments.

ALCO approves and reviews the banking book interest rate policy, the related methods of monitoring the risks and the interest rate risk limits. ALCO is also responsible for making the decision as to whether to adjust the Bank's interest rate risk appetite.

The Treasury Department is responsible for drafting the Bank's banking book interest rate risk policy and the related risk controlling methods. The Treasury Department is also responsible for advising RMD on the setting of and / or adjustment of the banking book interest rate risk limits, and the supervision and inspection of the implementation of the Bank's banking book interest rate risk management.

The Global Financial Market Department is responsible for maintaining the risk exposure of the Bank's marketable assets within defined limits.

IRRBB Control and Monitoring

In order to closely control the risk in the bond investment portfolio which contains the majority of the banking book interest rate risk, Value at Risk (VaR) exposure and PVBP exposure are calculated and reported on the portfolio on a daily basis.

The Bank's Middle Office function is responsible for monitoring whether the Global Financial Market Department is maintaining the risk in the Bank's bond investment portfolio within the defined limits.

7 Operational Risk

7.1 Operational Risk Overview

Operational risk relates to the risk of loss resulting from inadequate or failed internal processes, people or systems, or from external events. The operational risk team within Risk Management Department is responsible for providing oversight over operational risk across all departments, branches and subsidiaries of the Bank. The day-to-day identification and management of operational risk lies with the respective business and support departments.

7.2 Operational Risk Oversight and Governance

Operational risk oversight is provided firstly by a network of Risk Coordinators within each department, with a centralised Operational Risk team providing oversight to ensure consistency of practices across the Bank.

Oversight and governance arrangements for the setting and management of a robust operational risk management policy and culture are the responsibility of the Board and the Operational Risk Committee (ORC). The terms of reference and responsibilities of the ORC are set out below:

- Defining and reviewing, on a regular basis, the Operational Risk Policy, methodology and standards;
- Create awareness, across the Bank, of the need to manage operational risk effectively;
- Monitor and report the management of significant operational risks across the Bank;
- Ensure that appropriate training and guidance is given to raise staff awareness; and
- Report to Executive Management.

7.3 Operational Risk Management Tools

Given the current scope of the business, the level of operational risks to the Bank is not rated as significant and the overall level of operational risk is stable. Set out below are techniques used in the mitigation and management of the Bank's operational risks.

- **Control Self Assessment (CSA)**

The purpose of the control self assessment exercise is to identify and evaluate the inherent risks, the mitigating controls and the residual risks associated with each of the functional key processes. It also highlights areas for concern, and design and implements action plans for improved operational processes and systems.

CSAs are conducted annually and/or when significant change or an operational risk event occurs. The key operational risk events identified are then allocated to a risk owner. The risk owners are responsible for evaluating the severity and frequency of their allocated

operational risk event. A description and analysis of the implication of existing compensation controls in the mitigation of the operational risk event is provided. The residual risk will again be evaluated for severity and frequency.

- **Key Risk Indicator (KRI)**

KRIs are statistics and/or metrics that can provide insight into an activity's risk position. KRIs are a fundamental component of a full featured risk and control framework and sound risk management practice. KRIs are usually forward looking and reflect potential sources of operational risk. Their usefulness stems from potentially helping the business to reduce losses and prevent exposure by proactively dealing with a risk situation before an event actually occurs.

KRIs have established thresholds and are monitored on a red/amber/green basis. By doing so, it allows the business units to understand the implications, escalation process and actions to be taken when key risk indicator reaches the amber or red zones.

- **Operational Risk Events Reports (ORER)**

The ORER is a key part of operational risk; it captures both actual loss and potential loss within the bank. Data collected would include: the risk owner, the cause of the risk event, the effect, the date the event took place, the amount of the loss or potential loss and any action plan to mitigate reoccurrence.

The collection and analysis of loss data provides management information which is fed back into the operational risk management and mitigation process. ORERs are recorded back into loss database which is reviewed by operational risk management on regular basis in order to identify trends and patterns.

7.4 Operational Risk Capital Requirement

The Bank has adopted the Basic Indicator Approach for the determination of its capital requirement for operational risk. The capital requirement is 15% of the average over the previous three years annual gross income. The Bank's average gross income for the previous three years was £30.7 million and the capital requirement for operational risk as at 31 December 2010 was £4,550,000.