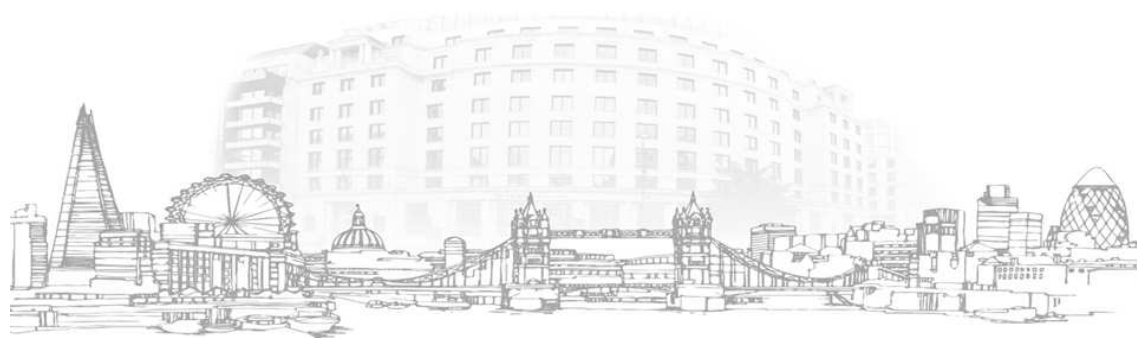




**Bank of China (UK) Limited**

## **Pillar 3 Disclosures**

31 December 2017



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## Version Control

Version	Date	Prepared by	Reviewed & Approved by	Main Changes
V1	11.03.2018	Ricardo Melgarejo	-	Creation
V2	14.03.2018	Ricardo Melgarejo	Haiying Chang Paul Brend	As advised
V3	16.03.2018	Ricardo Melgarejo	Jonathan Curry Steward Trussler (CFO)	As advised
V4	19.03.2018	Ricardo Melgarejo	Wei Shi (CRO)	As advised
V5	29.03.2018	Ricardo Melgarejo	Board	-

## Abbreviations

<b>Term</b>	<b>Definition</b>	<b>Term</b>	<b>Definition</b>
Annual Report	Annual Report and Financial Statements	EMEA	Europe, the Middle East and Africa
ALCO	Asset and Liability Committee	EBA	European Banking Authority
BOC UK	Bank of China (UK) Limited	EMC	Executive Management Committee
The Bank	Bank of China (UK) Limited	FCA	Financial Conduct Authority
BOC Group	Bank of China Limited	FMD	Financial Management Department
Basel Committee	Basel Committee on Banking Supervision	FSA	Financial Services Authority
BIA	Basic Indicator Approach	G-SIBs	Global Systemically Important Banks
BRC	Board Risk Committee	ICG	Individual Capital Guidance
BCC	Business Continuity Committee	IRRBB	Interest Rate Risk on Banking Book
CRD IV	Capital Requirement Directives IV	ICAAP	Internal Capital Adequacy Assessment Process
CEO	Chief Executive Officer	IRB	Internal Rating-Based
CFO	Chief Financial Officer	IFRS	International Financial Reporting Standards
COO	Chief Operating Officer	KRIs	Key Risk Indicators
CRO	Chief Risk Officer	L&C	Legal & Compliance Department
CET1	Common Equity Tier 1	NII	Net Interest Income
CFUs	Corporate Finance Units	ORC	Operational Risk Committee
CCyB	Countercyclical Capital Buffer	OTC	Over the Counter
CCR	Counterparty Credit Risk	PFE	Potential Future Exposure
CCF	Credit Conversion Factor	PRA	Prudential Regulation Authority
CQS	Credit Quality Step	RTS	Regulatory Technical Standards
CRM	Credit Risk Mitigation	RemCo	Remuneration Committee
CRPC	Credit Risk Policy Committee	RC	Replacement Cost
CVA	Credit Valuation Adjustment	RMD	Risk Management Department
CEM	Current Exposure Method	SFTs	Security Financing Transactions
EWIs	Early Warning Indicators	VaR	Value at Risk
EEPE	Effective Expected Positive Exposure		

# 1. Introduction

## Background

BOC UK was incorporated as a private limited company on 29<sup>th</sup> March 2007, a wholly owned subsidiary of BOC Group. BOC UK is regulated by the PRA and FCA. The Bank is authorised by the PRA. The Bank has been Basel compliant since 2008.

The Bank provides a comprehensive range of retail banking, corporate banking, trade financing and financial markets services in the UK. Our retail banking activities focus on branch banking. The Bank offers standard high street retail banking services including current accounts, savings accounts, debit cards, credit cards and mortgage products. The corporate and trade finance business encompass funding and advisory services for Chinese companies seeking to expand in the UK and EU.

To expand the territory of corporate clients for UK subsidiary and implement the globalisation strategy of the Group, the UK Subsidiary opened its Dublin Branch on 3<sup>rd</sup> July 2017. The strategy of the Dublin branch is to focus on corporate lending.

BOC UK follows the mission and strategy of the BOC Group, with a main focus on the UK market development.

## Basis of Disclosures

This disclosures report is prepared in accordance with the requirements set out in the Basel framework and CRD IV. The disclosures report is recommended to be read in conjunction with the Bank's Annual Report and Financial Statement 2017<sup>1</sup>.

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 (referring to Note 2: Basis of Preparation in Annual Report and Financial Statements 2017). Therefore this disclosure does not take into account any subsidiaries.

The Pillar 3 Disclosures 2017 have been prepared in accordance with regulatory capital adequacy concepts and rules, rather than in accordance with IFRS. Therefore, some information in this report is not directly comparable with the Bank's Annual Report and Financial Statement 2017. Explanations and notes are given where appropriate.

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<sup>1</sup> See <http://www.bankofchina.com/uk/aboutus>

## Regulatory Framework for Disclosures

BOC UK is supervised by the PRA in the UK. The Bank refers to the information from PRA for assessing capital adequacy and setting capital requirements. The capital was assessed for prudential regulatory reporting purposes in 2017 using the Basel III framework of the Basel Committee as implemented by the EU in the amended CRD IV and in the PRA's Rulebook for the UK banking industry.

The Basel framework is structured under 3 pillars:

- Pillar 1 minimal capital requirements
- Pillar 2 supervisory review process
- Pillar 3 market disciplines.

Pillar 3 complements the Pillar 1 and Pillar 2. The aim for Pillar 3 is to enhance market disciplines by developing a set of disclosure requirements which allow the market participants to assess certain specified information on the scope of application of Basel, capital, particularly risk exposures and risk assessment processes and hence the capital adequacy of the institution. Disclosures consist of both qualitative and quantitative information.

As part of Pillar 3 framework, the Bank is required to disclose all the material risks.

## Verification

The disclosures presented within this report have been verified and approved by various senior management members, through internal governance procedure and Pillar 3 procedure. The disclosures report does not require to be audited by the Bank's external auditor.

## Frequency, Media and Location of Publication

The Bank's full Pillar 3 disclosures report is produced on an annual basis and published concurrently with the financial report for the corresponding period on the Bank of China (UK) Ltd website: <http://www.bankofchina.com/uk/aboutus>

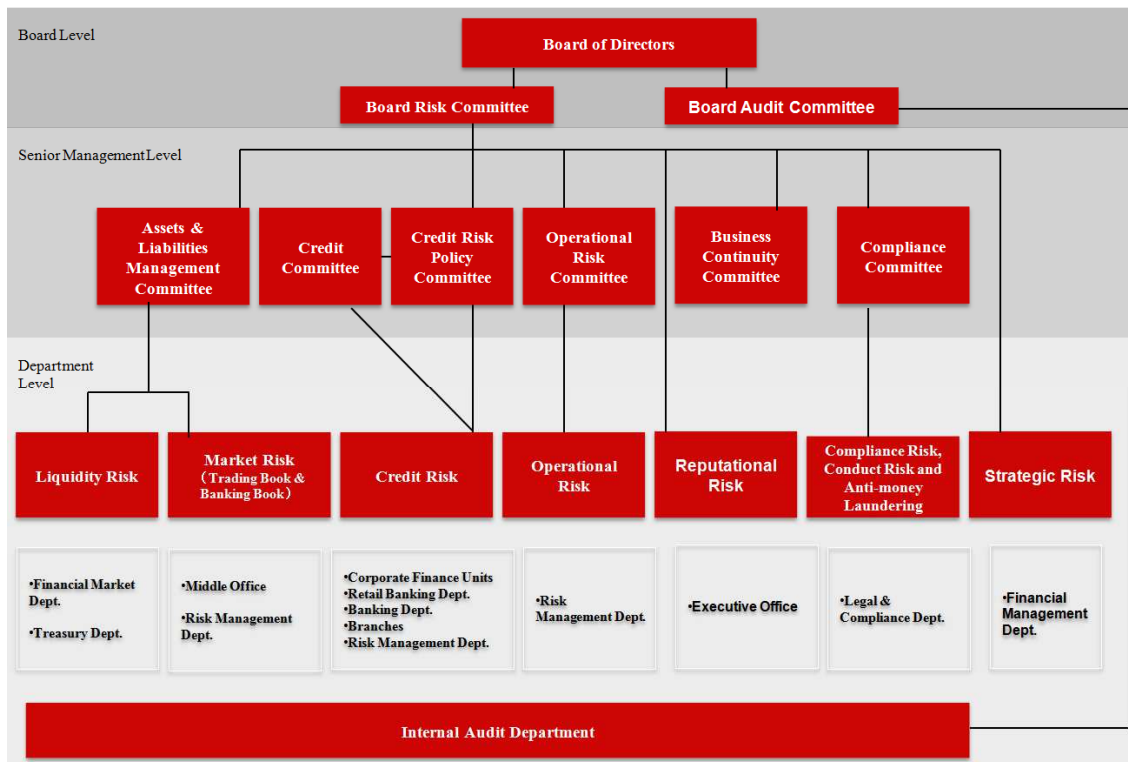
## 2. Risk Management Overview

Effective risk management is a key component of the Bank's strategy to deliver excellence. The Bank's business model is supported by a risk culture grounded in ensuring a sustainable risk appetite.

### Risk Governance

The Bank's committees monitor and challenge risk exposures against risk appetite. Each committee within the governance structure, illustrated in the chart below, is responsible for ensuring the risk and control environment. The reporting lines are clearly defined through the committee level, Senior Management level and Board level.

**BOC UK Risk Management Structure 2017**



**The Board** is the primary governing body of the Bank. It has the ultimate responsibilities for setting the risk management framework, defining and managing the Bank's risk appetite statement, and approving the Bank's risk policies and exposure limits.

During the reporting year, there were 9 directors on the Board (31<sup>st</sup> December 2017 there were 8). The Board believes that it is in the Bank's best interests to attract and retain the most competent and experienced directors by offering competitive terms of engagement, including the granting of indemnities on terms consistent with applicable statutory provisions.

**Board Audit Committee**, performs oversight over internal controls and compliance, financial reporting issues, external auditor liaison.

**Board Risk Committee ("BRC")**, is responsible for assisting the Board of Directors ("the Board") with the establishment and ongoing review of the risk strategies, rules and policies, and the defining of Risk Appetite, the oversight of risk management performance across the bank, approval of non-standard credits, and credits above the delegated limits of the CEO, as well as approval of delegated limit authorities.

**Executive Management Committee ("EMC")** is responsible for overall monitoring of operations, approval of new products and services, new systems and procedures, as well as approval of expenditure budget and business budget.

**The Senior Management**, including the CEO, CRO, CCO, CFO, COO and committees are delegated with power for daily management and control.

#### **Committees Reporting to BRC:**

- Asset and Liabilities Committee ("ALCO") - establishes and maintains asset and liability management policies and procedures, reviews and approves policies relating to market risk and liquidity management.
- Compliance Committee - oversees and supports the implementation of an effective and proactive compliance function.
- Credit Risk Policy Committee ("CRPC") - establishes and reviews the Bank's credit policies and related matters, including industry and country concentration limits.
- Credit Committee ("CC") - is responsible for new facility assessment, classification review, provisioning, and other related matters.
- Operational Risk Committee ("ORC") - is responsible for reviewing operational risk, monitoring framework and operational risk compliance.
- Business Continuity Committee ("BCC") - oversees and supports the implementation and maintenance of an effective business continuity infrastructure and disaster recovery planning function.

Board meetings, Board Audit Committee, BRC, CRPC, ORC, BCC and Compliance Committee meet on a quarterly basis<sup>2</sup>. ALCO will meet physically as deemed required by the Chairman or Deputy Chairman of the Committee. CC meets as required in response to credit limit applications.

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<sup>2</sup> BRC and CRPC Adhoc meetings are held as required.

## Five Year Strategic Plan (2016-2020)

The core mission of the Bank until 2020 is to upgrade its business model. The mission cause huge challenges for the Bank on management of the related risk. Therefore, a comprehensive risk management framework and system has been established. Through the plan period, the focus is on maintaining efficient and effective risk management practice to support the business development by identifying and managing risks. To achieve this, the key focus areas are as follows:

### Risk Appetite

Risk Appetite is the core instrument for aligning overall business strategy, capital allocation and risk management. The Board, BRC and the Senior Management set risk appetite through balancing risk and return under BOC Group's principles "Rational, Stable and Prudent".

The Bank's Risk Appetite Statement defines the aggregate amount and type of risk the Bank is willing to pursue or avoid in achieving its strategic goals. All strategic business plans for functional areas must be consistent with the risk appetite.

### Risk management culture

The Bank recognizes the need to emphasise risk management as the key part of the corporate culture and is applicable to all staff.

### Ongoing Enhancement of the Comprehensive Risk Management System

The Bank's long-term risk management objective is to enhance the efficiency of the overall risk management system, and strengthen risk management while supporting business sustainable development. The Bank also has established and continues an effective reporting system. Risk Management Department submit Management Information Risk Report monthly and quarterly along with the Risk appetite Indicator Monitoring Report (RAIM). The comprehensive report covers credit, operational, market risk disclosure and analysis and also liquidity and capital in RAIM.

### Three Lines of Defence

The Bank adopts three lines of defence model across all risk areas.

- The **first line defence** consists of the business frontline staff (i.e. the customer-facing business / processing departments) who are responsible for ensuring that the risk and control environment is established as part of the day-to-day operations, this will involve the identification, design and implementation of controls within the business.
- The **second line defence** consists of the oversight functions within the Bank, being the Legal and Compliance Department, Risk Management Department, Middle Office and the various Committees within the Bank each of these functions reports into.
- The **third line defence** consists of the internal audit function of the Bank, which reports directly in to the Board Audit Committee.

### 3. Capital Resources

#### Total Capital Resources

The Bank established its capital base externally through capital injection from BOC Group. The Bank retains the option to increase its capital internally by retained earnings. The capital resources comprise Tier 1 and Tier 2 capital as set out in Table 1. The PRA uses risk asset ratios as one of the measures for capital adequacy in the UK banking sector. All the risk asset ratios of the Bank are CRD IV compliant.

**Table 1: Total capital resources and risk asset ratios**

(£'000)	2017	2016
CET 1 Capital: Ordinary share capital	250,000	250,000
Audited retained earnings <sup>3</sup>	24,958	24,958
<b>Total Tier 1 Capital</b>	<b>274,958</b>	<b>274,958</b>
<b>Tier 2 Capital:</b>		
Qualifying subordinated debt	60,000	60,000
<b>Total Tier 1 and 2 capital after deductions</b>	<b>334,958</b>	<b>334,958</b>
<b>Risk-weighted assets (RWA)</b>	<b>931,206</b>	<b>1,002,116</b>
<b>Risk Asset Ratios</b>		
CET 1 capital ratio	30%	27%
Tier 1 capital ratio	30%	27%
Total capital ratio	36%	33%

**CET 1 capital:** consists of ordinary share capital and retained earnings. CET1 capital remained the same over the reporting period. The retained earnings represent the Bank's audited accumulated accounting profits after proposed and paid dividends. The Bank currently has not issued any innovative Tier 1 instruments. As at 31 December 2017, there is no reconciliation differences between the amounts disclosed as Tier 1 capital to those treated as equity under IFRS.

**Tier 2 capital:** includes qualifying subordinated debt of £60M, which was issued on 20 September 2007 on terms for inclusion in the Bank's capital resources. The debt is repayable upon notice of 5 years and one day. In the event of the Bank's winding-up, the subordinated debt is subject to the claims of depositors and all other creditors of the Bank. Further details are in Note 28 of the Bank's Annual Report and Financial Statement 2017.

The Bank's policy is to maintain a strong capital base so as to maintain market confidence and sustainable business development. The impact of the capital level on shareholders' return is also recognised by the Bank to strike a balance between higher returns and greater gearing risk. The bank has complied with all externally imposed capital requirements throughout the period.

<sup>3</sup> Net of recommended £31,606,000 dividend for the year ended 31<sup>st</sup> December 2017. Capital resources are therefore expected to be unchanged.

## Leverage Ratio

In January 2014, the Basel Committee published a revised Basel III leverage ratio framework<sup>4</sup>, which includes a number of amendments to the original calculations of the exposure measure. The framework introduced a simple, transparent, non-risk based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements. The framework requires a minimum leverage ratio of 4%.

A Bank's total leverage exposure measure is the sum of the following exposures: 1) on-balance sheet exposures; 2) derivative exposures; 3) securities financing transaction exposure; and 4) off-balance sheet items.

In January 2015, the existing CRD IV rules on the calculation of leverage ratio were amended to align with the European Commissions' interpretation of the revised Basel leverage ratio framework. According to CRD IV rules, the leverage ratio is calculated by dividing Tier 1 capital resources by a defined measure of on-balance sheet assets and off-balance sheet items.

**Table 2: Leverage ratio**

<b>Total Capital Resources (£'000)</b>	<b>2017</b>	<b>2016</b>
<b>Tier 1 capital for leverage ratio:</b>	<b>274,958</b>	<b>274,958</b>
CET 1 capital: Ordinary shares	250,000	250,000
Audited retained earnings	24,958	24,958
<b>Statutory balance sheet assets</b>	<b>1,539,221</b>	<b>1,549,898</b>
Cash and cash equivalents	281,944	311,917
Loans and advances to banks	83,706	24,270
Loans and advances to customers	1,054,454	1,159,696
Derivative financial instruments	1,717	4,577
Prepayments, accrued income and other assets	5,204	4,762
Available for sale financial investments	12	40,716
Held to maturity financial investments	107,478	-
Deferred tax assets	1,462	562
Property, plant and equipment	3,149	3,276
Intangible assets	95	122
Investment in subsidiary companies	-	-
<b>Derivatives adjustments</b>	<b>-</b>	<b>-</b>
<b>Securities financing transaction adjustments</b>	<b>-</b>	<b>-</b>
<b>Off-balance sheet assets</b>	<b>255,426</b>	<b>251,468</b>
Off-balance sheet items	255,426	251,468
Regulatory deductions and other adjustments	-	-
<b>Total leverage exposure</b>	<b>1,794,647</b>	<b>1,801,366</b>
<b>Leverage ratio</b>	<b>15%</b>	<b>15%</b>

The leverage ratio is 15%, which is well above Basel's requirement. The Bank does not face an issue of excessive leverage. The main reasons contributing to a relatively high leverage ratio are due to:

- Level of Tier 1 capital resources
- Small proportion of off-balance assets.

<sup>4</sup> BOC UK is required to publicly disclose the leverage ratio on a consolidated basis from 1 January 2016.

## 4. Capital Adequacy

The Bank's capital requirement is set by the PRA. Since 2008, the Bank has been compliant with Basel II framework in regulatory capital requirement and subsequently with Basel III framework implemented in 2010. Basel III strengthened the Basel rules, which feature a redefined and higher capital requirement.

Capital ratios remain the international standards for measuring capital adequacy. Senior Management use regulatory capital ratios to monitor the Bank's capital position. The PRA's approach to such measurement based upon Basel III is now primarily based on monitoring the relationship of the capital resources requirement, which is 8% of the RWAs to available capital resources.

The Pillar I minimum requirement for capital is supplemented Pillar 2A firm specific Individual Capital Guidance (ICG) and a framework of regulatory capital buffers.

Under Pillar 2A, additional minimum requirements are currently set by the PRA through the issuance of bank specific ICG. This reflects a point-in-time estimate by the PRA, which may change over time, of the minimum amount of capital that is needed by the bank to cover risks not covered by Pillar I.

The Bank is also required to maintain a number of regulatory capital buffers, which are required to be met by CET1 capital.

Capital conservation buffer (CCB). A buffer of 2.5% of RWA being phased in by January 2019. In 2017 this was 1.25% .

Countercyclical buffer (CCyB). A buffer designed to require additional capital to remove or reduce the build up of systemic risk in times of credit crisis.

PRA buffer. An additional buffer set as part of the capital planning process which takes into account the CCB and CCyB.

## **ICAAP**

A key input to the ICG setting process is the Bank's ICAAP. In line with the PRA requirements, the Bank has adopted the ICAAP approach since 2008. The Bank's ICG in force is subject to PRA's Supervisory Review and Evaluation Process.

The Bank's ICAAP documents the internal process and methodology used to assess current and forecast future capital requirements under the Basel capital requirement framework. ICAAP is designed to cover a full scope of risks inherent in the Bank's business activities and operations. ICAAP is fully embedded in the corporate governance and risk management framework. It is conducted on an annual basis and under close supervision by Senior Management. The final submission has to seek internal approval from the BRC and the Board.

## **Stress Testing**

Stress testing is an integral part of the ICAAP framework. It builds upon the results of financial forecasts and material risk assessment, and feeds into the Bank's capital planning process.

The Bank applies stress testing under a set of economic factors, market factors, operational risk factors and regulatory factors. The scenario setting is in line with the Annual Cyclical Scenario (ACS) set by the PRA anchor scenarios. For each risk factor, projection is made individually for Base Case Scenario, Moderate Scenario and Severe Scenario over a time horizon (3-5 years forecast).

As a capital risk management process, stress testing and scenario analysis provide an important complement to quantitative risk management approaches. As credit risk is the Bank's dominant risk, the stress testing results for capital adequacy also provides a bridge between credit risk management and senior management's strategic actions for evaluating the impact of different business options on the risk appetite.

## Overview of RWA

RWA forms the denominator of the risk-based capital requirements. The RWA overview was brought into disclosures by the Basel Committee in January 2015. Minimum capital requirements are calculated as 8% of the RWAs. A further breakdown and comparison of the RWA and minimal capital requirements are illustrated in below Table 3.

**Table 3: Overview of RWA**

£'000	2017		2016	
	RWA	Min Capital	RWA	Min Capital
<b>Credit risk</b>	<b>757,906</b>	<b>60,633</b>	<b>840,455</b>	<b>67,236</b>
(including Counterparty Credit and Dilution Risks And Free Deliveries)				
Of which standardised approach (SA)	757,906	60,633	840,455	67,236
Of which internal rating-based (IRB) approach	-	-	-	-
<b>Credit Valuation Adjustment</b>	<b>2,526</b>	<b>202</b>	<b>2,366</b>	<b>189</b>
Of which standardised approach	2,526	202	2,366	189
Equity positions in banking book under market-based approach	-	-	-	-
Equity investments in funds-look-through approach	-	-	-	-
Equity investments in funds-mandate-based approach	-	-	-	-
Equity investments in funds-fall-back approach	-	-	-	-
Settlement risk	-	-	-	-
Securitisation exposure in banking book	-	-	-	-
Of which IRB ratings-based approach (RBA)	-	-	-	-
Of which IRB supervisory Formula Approach (SFA)	-	-	-	-
Of which SA/simplified supervisory formula approach (SSFA)	-	-	-	-
<b>Market risk</b>	<b>9,694</b>	<b>776</b>	<b>11,206</b>	<b>896</b>
Of which standardised approach (SA)	9,694	776	11,206	896
Of which internal model approaches (IMM)	-	-	-	-
<b>Operational risk</b>	<b>161,079</b>	<b>12,886</b>	<b>148,088</b>	<b>11,847</b>
Of which Basic Indicator Approach	161,079	12,886	148,088	11,847
Of which Standardised Approach	-	-	-	-
Of which Advanced Measurement Approach	-	-	-	-
Amounts below thresholds for deduction (subject to 250% RW)	-	-	-	-
Floor adjustment	-	-	-	-
<b>Total</b>	<b>931,206</b>	<b>74,496</b>	<b>1,002,116</b>	<b>80,169</b>

## Capital Adequacy

**Table 4: Capital adequacy under Pillar 1**

(£'000)	2017	2016
Credit Risk (Standardised Approach)	60,633	67,236
Market Risk (Foreign Exchange PRR)	776	896
Operational Risk (Basic Indicator Approach)	12,886	11,847
Counterparty Credit Risk (including CVA)	202	189
<b>Total Pillar 1 minimum capital requirement</b>	<b>74,496</b>	<b>80,169</b>
<b>Total capital resources</b>	<b>334,958</b>	<b>334,958</b>
<b>Excess of capital resources over Pillar 1 minimum capital requirement</b>	<b>260,462</b>	<b>254,789</b>

The Bank's Pillar 2 capital requirement is assessed to reflect IRRBB and concentration risk.

## Countercyclical Capital Buffers (CCyB)

In December 2010, Basel issued guidance for global regulatory standards on bank capital adequacy and liquidity, including a countercyclical capital buffer.

The countercyclical capital buffer aims to ensure that banking sector capital requirements take account of the macro-financial environment in which banks operate. Its primary objective is to use a buffer of capital to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth that have often been associated with the build-up of system-wide risk. Due to its countercyclical nature, the countercyclical capital buffer is a tool that enables the Financial Policy Committee (FPC) in the UK, and the equivalent in other countries, to require an additional cushion of capital when risks are building up. In downturns the FPC and overseas equivalent can reduce the buffer requirement to reduce the risk that the supply of credit will be constrained by regulatory capital requirements that could undermine the performance of the real economy and result in additional credit losses in the banking system.

In the UK, the FPC aims to ensure the UK financial system is resilient to, and prepared for, the wide range of risks it could face — so that the system could support the real economy, even in difficult conditions.

Following the latest meeting in November 2017, the FPC will raise the UK CCyB rate from 0.5% to 1%, with binding effect from 28 November 2018.

Jurisdiction	CCyB regulations	Current CCyB			Future CCyB		
		Policy announcement	Effective date	Add-on (% of RWA)	Policy announcement	Effective date	Add-on (% of RWA)
United Kingdom	Financial Stability Report	Financial Stability Report June 2017	27.06.2018	0.50%	Financial Stability Report November 2017	28.11.2018	1%

Other national authorities also determine the appropriate CCyBs that should be applied to exposures in their jurisdiction. CCyBs have started to apply for Bank of China's exposures to other jurisdictions; however based on current exposures these are not material.

## Global Systemically Important Banks (G-SIBs)

BOC UK is not identified as G-SIBs, although BOC Group is.

## Reconciliation between IFRS and Regulatory Balance Sheets

The consolidation of IFRS balance sheet scope is identical to that with regulatory scope in 2017. Therefore there are no reconciliation differences.

A further breakdown of the regulatory risk categories are illustrated below.

**Table 5: Reconciliation between IFRS and Regulatory balance sheets**

<b>2017 Reconciliation (£'000)</b>	<b>IFRS/ Regulatory balance sheet</b>
<b>Assets</b>	
Cash and cash equivalents	281,944
Loans and advances to banks	83,706
Loans and advances to customers	1,054,454
Derivative financial instruments	1,717
Prepayments, accrued income and other assets	5,204
Available for sale financial investments	12
Held to maturity financial investments	107,478
Deferred tax assets	1,462
Property, plant and equipment	3,149
Intangible assets	95
Investment in subsidiary companies	-
<b>Total Assets</b>	<b>1,539,221</b>
<b>Liabilities</b>	
Deposits from banks	123,122
Deposits from customers	1,019,007
Derivative financial instruments	257
Other liabilities	20,158
Accruals and deferred income	4,176
Current tax liabilities	5,447
Deferred tax liabilities	-
Subordinated liabilities	60,000
<b>Total liabilities</b>	<b>1,232,167</b>
<b>Equity</b>	
Authorised and called up share capital	250,000
Retained earnings	57,022
Available for sale reserve	32
<b>Total shareholders' equity</b>	<b>307,054</b>
<b>Total shareholders' equity &amp; liabilities</b>	<b>1,539,221</b>

## 5. Credit Risk

### Credit Risk Management and Controls

Credit risk is defined as the risk that parties with whom the Bank has contracted fail to meet their obligations (both on and off-balance sheet). Credit risk appetite is monitored and reported on a monthly basis through a suite of risk metrics derived from credit portfolio performance measures. Credit risk appetite limits and credit risk policies are reviewed regularly to ensure that the metrics continue to reflect the Bank's risk appetite appropriately. Credit risk management and controls also depend on increase of the professional personnel for key products, to proactively adjust credit portfolio to achieve more effective portfolio risk management through industry, country and other quota allocation mechanism.

### Credit Risk Capital Requirement: Standardised Approach

The standardised approach is applied for credit risk. The Bank's minimum capital requirement for credit risk is expressed as 8% of the risk weighted exposure under each of the applicable standardised credit risk exposure classes, illustrated below:

Table 6: Capital requirement for credit risk under Standardised Approach

£'000	2017		2016	
	RWA	Capital Requirement	RWA	Capital Requirement
Central governments or central banks	-	-	-	-
Corporate	497,628	39,810	600,989	48,079
Institutions	483	39	18,040	1,443
Retail	613	49	629	50
Secured by mortgages on immovable property	236,310	18,905	203,382	16,271
Short term claims on institutions & corporate	5,755	460	5,379	430
Past due items	3,716	297	314	25
Other items	13,401	1,072	11,722	938
<b>Total</b>	<b>757,906</b>	<b>60,633</b>	<b>840,455</b>	<b>67,236</b>

The past due items are related to residential mortgages, credit cards and overdrafts. Other items on the asset class mainly relate to cash and fixed assets.

## Credit Risk Exposures

In general, credit risk exposures in the UK take the largest part of total exposure.

**Table 7: Gross credit exposure under Standardised Approach**

£'000	2017	2016
	Year End Exposure	Year End Exposure
Central governments or central banks	337,882	248,098
Corporate	508,043	615,247
Institutions	2,415	36,081
Retail	873	917
Secured by mortgages on immovable property	674,350	579,498
Short term claims on institutions and corporate	23,268	23,614
Past due items	2,478	210
Other items	13,887	12,931
<b>Grand Total</b>	<b>1,563,196</b>	<b>1,516,596</b>

**Table 8: Geographic distribution of credit exposure**

£'000	UK	Other EU Countries	North America	Rest of the World	Total
<b>2017</b>					
Central governments or central banks	337,882	-	-	-	337,882
Corporate	262,343	54,672	66,422	124,606	508,043
Institutions	-	-	-	2,415	2,415
Retail	775	1	10	87	873
Secured by mortgages on immovable property	258,395	5,241	1,009	409,705	674,350
Short term claims on institutions and corporate	19,045	31	629	3,563	23,268
Past due items	1,796	-	-	682	2,478
Other items	13,887	-	-	-	13,887
<b>Grand Total</b>	<b>894,122</b>	<b>59,945</b>	<b>68,070</b>	<b>541,058</b>	<b>1,563,196</b>
<b>2016</b>					
Central governments or central banks	248,098	-	-	-	248,098
Corporate	274,599	78,635	83,004	179,009	615,247
Institutions	10,673	-	-	25,408	36,081
Retail	826	1	5	85	917
Secured by mortgages on residential property	579,498	-	-	-	579,498
Short term claims on institutions and corporate	10,477	25	516	12,596	23,614
Past due items	210	-	-	-	210
Other items	12,931	-	-	-	12,931
<b>Grand Total</b>	<b>1,137,312</b>	<b>78,661</b>	<b>83,525</b>	<b>217,098</b>	<b>1,516,596</b>

The geographic distribution of “Secured by mortgages on residential property” is different from 2016 following the Capital Requirement Regulation “the risk of the borrower shall not materially depend on upon the performance of the underlying property, but on the underlying capacity of the borrower”.

Key movements by gross credit exposure and geographical area are as follows:

- “Central governments” increased by £90M and “Secured by mortgages” by £95M
- “Corporates” decreased by £107M and “Institutions” by £34M due to some repayments in 2017.

**Table 9: Industry distribution of gross credit exposure**

<b>Industry Distribution of Gross Credit Exposure 2017 (£'000)</b>			
<b>Exposure Class</b>	<b>Industry Category</b>	<b>Gross Exposure</b>	
Central governments or central banks Corporate	Financial intermediation	337,882	
	Accommodation And Food Services Activities	3,022	
	Education	25,678	
	Electricity, Gas And Water Supply	19,973	
	Financial intermediation	23,764	
	Human Health And Social Work	22,238	
	Manufacturing	137,307	
	Mining And Quarrying	289	
	Real estate, professional services and support activities	106,312	
	Transport, storage and communication	152,044	
	Wholesale and retail trade	17,414	
	Institutions	Financial intermediation	2,415
		Individuals	873
Retail Secured by mortgages on immovable property	Accommodation And Food Services Activities	33	
	Electricity, gas and water supply	285	
	Individuals	668,163	
	Manufacturing	33	
	Real estate, professional services and support activities	5,836	
Short term claims on institutions and corporate	Financial intermediation	23,268	
	Individuals	2,478	
Past due items	Financial intermediation	13,794	
	Individuals	93	
<b>Grand Total</b>		<b>1,563,196</b>	

<b>Industry Distribution of Gross Credit Exposure 2016 (£'000)</b>			
<b>Exposure Class</b>	<b>Industry Category</b>	<b>Gross Exposure</b>	
Central governments or central banks Corporate	Financial intermediation	248,098	
	Accommodation And Food Services Activities	3,345	
	Agriculture, Hunting And Forestry	10,132	
	Real estate, professional services and support activities	81,644	
	Manufacturing	132,674	
	Education	28,126	
	Electricity, Gas And Water Supply	59,175	
	Individuals	574	
	Transport, storage and communication	191,319	
	Mining And Quarrying	51,652	
	Wholesale and retail trade	21,194	
	Financial intermediation	11,097	
	Human Health And Social Work	24,316	
	Institutions	Financial intermediation	36,081
		Individuals	132
	Retail Secured by mortgages on immovable property	Individuals	785
		Accommodation And Food Services Activities	539
Real estate, professional services and support activities		4,810	
Electricity, gas and water supply		291	
Individuals		573,364	
Transport, storage and communication		446	
Short term claims on institutions and corporate	Manufacturing	49	
	Financial intermediation	23,614	
Past due items	Individuals	210	
	Financial intermediation	3,398	
Other items	Individuals	9,533	
<b>Grand Total</b>		<b>1,516,598</b>	

As at 31<sup>st</sup> December 2017, “Individuals” accounts for 43% of the total portfolio mainly related to residential mortgages.

“Financial intermediation of Short term claims on institutions and corporate” contains mainly “due from overseas subsidiaries” and “due from overseas banks”

**Table 10: Residual contractual maturity of credit exposure**

2017 (£'000)	Up to 12 months	1-5 years	More than 5 years	Total
Central governments or central banks	-	337,882	-	337,882
Corporate	45,260	370,995	91,787	508,043
Institutions	2,415	-	-	2,415
Retail	855	-	18	873
Secured by mortgages on immovable property	59	6,039	668,253	674,350
Short term claims on institutions and corporates	23,268	-	-	23,268
Past due items	2,478	-	-	2,478
Other items	13,887	-	-	13,887
<b>Grand Total</b>	<b>88,222</b>	<b>714,916</b>	<b>760,057</b>	<b>1,563,196</b>

2016 (£'000)	Up to 12 months	1-5 years	More than 5 years	Total
Central governments or central banks	-	248,098	-	248,098
Corporate	143,391	311,634	160,222	615,247
Institutions	24,818	10,261	1,002	36,081
Retail	876	-	41	917
Secured by mortgages on immovable property	99	3,230	576,169	579,498
Short term claims on institutions and corporates	23,614	-	-	23,614
Past due items	210	-	-	210
Other items	12,931	-	-	12,931
<b>Grand Total</b>	<b>205,939</b>	<b>573,223</b>	<b>737,434</b>	<b>1,516,596</b>

#### Key points:

- The exposure up to 12 months decreased by £118M due to some repayments of “Corporate” and “Institutions”.
- The exposure between 1 and 5 years residual maturity increased by £142M. This movement was mainly due to “central governments or central banks”.
- The long-term exposure is mainly related to residential mortgages.

## Impairment Provisions

The Bank defines past due loan as an instalment on the whole or a part of the loan which is not received within 90 days of the instalment. The Bank identifies impairment through a list of prescribed credit events of the borrower. The impairment loss refers the difference between the carrying value of the loan and the present value of estimated future cash flow.

## Provisioning for Loans and Advances

Allowance for impairment is established when objective evidence is identified:

- Significant financial difficulty of the obligor;
- A breach of contract, such as a default, or delinquency in interest or principal payments for a period exceeding 90 days, or the borrower has been exposed to substantial risk although the debt is overdue less than 90 days;
- The creditor for economic or legal reasons relating to the borrower's financial difficulty, granting to borrower a concession that the lender would not otherwise consider;
- It is becoming probable that the borrower will enter bankruptcy or other financial reorganization;
- There are observable data indicating adverse changes in the payment status of the borrower or adverse changes in the industry conditions which the borrower is engaged in, increase in unemployment rate in the geographical area of the borrower, and a decrease in mortgage price in the relevant area; and
- Other objective evidence that an asset or group of similar assets is impaired.

**Table 11: Analysis of past due, impaired and provision to loans and advances by industry**

<b>2017 (£'000)</b>	<b>Past Due but not impaired</b>	<b>Of which Non-Performing</b>	<b>Provision</b>
Accommodation And Food Services Activities	-	-	1
Agriculture, Hunting And Forestry	-	-	-
Education	-	-	11
Electricity, Gas And Water Supply	-	-	9
Financial intermediation	-	-	177
Human Health And Social Work	-	-	10
Individuals and individual trusts	(13,077)	(463)	296
Manufacturing	-	-	61
Mining And Quarrying	-	-	-
Real estate, professional services and support activities	-	-	49
Transport, storage and communication	-	-	67
Wholesale and retail trade	-	-	8
<b>Grand Total</b>	<b>(13,077)</b>	<b>(463)</b>	<b>689</b>

<b>2016 (£'000)</b>	<b>Past Due but not impaired</b>	<b>Of which Non-Performing</b>	<b>Provision</b>
Accommodation And Food Services Activities	-	-	2
Agriculture, Hunting And Forestry	-	-	6
Education	-	-	18
Electricity, Gas And Water Supply	-	-	37
Financial intermediation	-	-	204
Human Health And Social Work	-	-	15
Individuals and individual trusts	(12,390)	(1,823)	358
Manufacturing	-	-	82
Mining And Quarrying	-	-	32
Real estate, professional services and support activities	-	-	54
Transport, storage and communication	-	-	119
Wholesale and retail trade	-	-	13
<b>Grand Total</b>	<b>(12,390)</b>	<b>(1,823)</b>	<b>940</b>

**Table 12: Analysis of past due, impaired and provision by geographical region**

<b>2017 (£'000)</b>	<b>Past Due</b>	<b>Impaired</b>	<b>Provision</b>
UK	(12,614)	(463)	394
Other European Countries	-	-	26
North America	-	-	30
Rest of the World	-	-	238
<b>Grand Total</b>	<b>(12,614)</b>	<b>(463)</b>	<b>689</b>

<b>2016 (£'000)</b>	<b>Past Due</b>	<b>Impaired</b>	<b>Provision</b>
UK	(11,060)	(1,823)	519
Other European Countries	-	-	116
North America	-	-	46
Rest of the World	-	-	259
<b>Grand Total</b>	<b>(11,060)</b>	<b>(1,823)</b>	<b>940</b>

- The impaired amount of £0.46M consisted of 3 residential mortgages which fell into non-performing category and some overdue credit cards.
- The past due balances of £12.6M related to residential mortgages.
- The provision amount decreased by £0.25M mainly due to a decrease in the collective provisional allowance.

The movement in the impairment provision between 2017 year-end and 2016 year-end is shown in Table 13. This table is also available in the 2017 annual report.

**Table 13: Allowances for impairment: provisions to loans and advances**

<b>£'000</b>	<b>Specific</b>		<b>Collective</b>	
	<b>Loans and advances to banks</b>	<b>Loans and advances to customers</b>	<b>Loans and advances to banks</b>	<b>Loans and advances to customers</b>
<b>Balance as at 1 January 2017</b>	-	<b>3</b>	<b>47</b>	<b>890</b>
Increase in impairment	-	15	-	91
Recovery	-	(4)	-	-
Reversal of impairment	-	-	(47)	(293)
Charge (release) in income statement	-	11	(47)	(202)
Amounts written off (for credit and fraud)	-	(13)	-	-
<b>Balance at 31 December 2017</b>	-	<b>1</b>	-	<b>688</b>
<b>Balance as at 1 January 2016</b>	-	<b>33</b>	<b>81</b>	<b>376</b>
Increase in impairment	-	83	21	574
Recovery	-	(4)	-	-
Reversal of impairment	-	-	(55)	(60)
Charge (release) in income statement	-	79	(34)	514
Amounts written off (for credit and fraud)	-	(109)	-	-
<b>Balance at 31 December 2016</b>	-	<b>3</b>	<b>47</b>	<b>890</b>

## Provisioning for Financial Assets

Impairment for financial assets is identified when there is a significant or prolonged decline in the fair value of the assets below its original cost.

If in a subsequent period, the fair value of the asset increases, which can be objectively related to an event occurring after the recognition of the impairment loss, the impairment loss is reversed through the income statement.

**Table 14: Allowances for impairment: Financial Investments**

<b>£'000</b>	<b>Movement in fair value recognized in equity</b>	<b>Impairment</b>
<b>Balance as at 1 January 2017</b>	<b>399</b>	-
Changes in fair values	(420)	-
Reversal of impairment	-	-
Amounts written off	-	-
<b>Exchange-rate movements</b>	-	-
<b>Balance as at 31 December 2017</b>	<b>(21)</b>	-
<b>Balance as at 1 January 2016</b>	<b>210</b>	-
Changes in fair values	189	-
Reversal of impairment	-	-
Amounts written off	-	-
<b>Exchange-rate movements</b>	-	-
<b>Balance as at 31 December 2016</b>	<b>399</b>	-

IFRS 9 Financial Instruments, issued in July 2014, introduces new requirements for classifying and measuring financial assets, hedge accounting and impairments and is likely to affect the bank's accounting for financial assets. The standard is effective from 1 January 2018, endorsed by the EU. Based on 31 December 2017 data and the current implementation status of IFRS 9 as described in further details in the Financial Statements for the year end 31<sup>st</sup> December 2017, the Bank estimates the adoption of IFRS 9 to lead to an overall reduction in the Bank's total shareholders' equity of approximately £0.5m before tax. This reduction is predominately driven by the impairment requirements of IFRS 9.

## Credit Asset Quality

Table 15: Credit quality of assets

£'000	Gross carrying values <sup>5</sup> of		Allowances/ impairment	Net values
	Defaulted exposures <sup>6</sup>	Non-defaulted exposures		
<b>2017</b>				
Loans	463	1,138,385	689	1,138,159
Debt Securities	-	107,478	-	107,478
OBS exposures	-	291,616	-	291,616
<b>Total</b>	<b>463</b>	<b>1,537,479</b>	<b>689</b>	<b>1,537,253</b>
<b>2016</b>				
Loans	1,823	1,183,083	940	1,183,966
Debt Securities	-	40,708	-	40,708
OBS exposures	-	251,468	-	251,468
<b>Total</b>	<b>1,823</b>	<b>1,475,259</b>	<b>940</b>	<b>1,476,142</b>

Table 16: Changes of defaulted loans and debt securities

	Carrying values (£'000)
<b>Defaulted loans and debt securities at 30 June 2017</b>	<b>2,466</b>
Loans and debt securities that have defaulted since the last reporting period	452
Returned to non-defaulted status	(2,348)
Amounts written off	-
Other changes	(107)
<b>Defaulted loans and debt securities at 31 December 2017</b>	<b>463</b>
<b>Defaulted loans and debt securities at 30 June 2016</b>	<b>1,756</b>
Loans and debt securities that have defaulted since the last reporting period	355
Returned to non-defaulted status	(288)
Amounts written off	-
Other changes	-
<b>Defaulted loans and debt securities at 31 December 2016</b>	<b>1,823</b>

Movements highlight:

- The above changes defaulted exposures related to retail loans only. There was no default arising from debt securities.
- The defaulted amount £2.5M in June 2017 related to 13 residential mortgages and some credit cards.
- After June there was one retail loan recovery and 9 residential mortgages reverted to non-defaulted status.

<sup>5</sup> The amount is the gross exposure of any credit conversion factors (CCF) or credit risk mitigation (CRM) techniques, but after deduction of write-offs.

<sup>6</sup> The defaulted exposure refers to the non-performing exposure.

## Credit Quality Step (CQS) Analysis

In the assessment of credit risk under Standardised Approach, the Bank uses ratings assigned by the PRA's recognised External Credit Assessment Institutions to determine risk weight and RWA.

Rated and unrated counterparties under the standardised approach governing rule, each exposure must be assigned to one of the six credit steps if a rating is available. After assignment to a quality step, exposure class and maturity are then used to determine the risk weight percentage. Where a credit rating is not available, a default treatment is applied as specified by regulatory guidance.

The Bank has not used any export credit agencies for rating purposes. The bank follows the provision of the CRD IV where external ratings cannot be obtained.

The breakdown of credit risk exposures under standardised approach by asset class and risk weight, corresponding to the riskiness attributed to the exposure.

**Table 17: Credit exposures by asset classes and risk weights**

Risk weight	0%	20%	35%	50%	75%	100%	150%	250%	Total credit exposures (post CCF&CRM)
<b>Asset classes</b>									
<b>2017(£'000)</b>									
Central governments or central banks	337,882	-	-	-	-	-	-	-	337,882
Corporate	-	-	-	18,411	-	489,631	-	-	508,043
Institutions	-	2,415	-	-	-	-	-	-	2,415
Retail	-	-	-	-	873	-	-	-	873
Secured by mortgages on immovable property	-	-	665,067	9,284	-	-	-	-	674,350
Short term claims on institutions and corporate	-	19,597	-	3,671	-	-	-	-	23,268
Past due items	-	-	-	-	-	-	2,478	-	2,478
Other items	1,330	-	-	-	-	11,996	-	562	13,887
<b>Total</b>	<b>339,211</b>	<b>22,012</b>	<b>665,067</b>	<b>31,366</b>	<b>873</b>	<b>501,627</b>	<b>2,478</b>	<b>562</b>	<b>1,563,196</b>
<b>2016(£'000)</b>									
Central governments or central banks	248,098	-	-	-	-	-	-	-	248,098
Corporate	-	-	-	14,753	-	600,494	-	-	615,247
Institutions	-	-	-	36,081	-	-	-	-	36,081
Retail	-	-	-	-	917	-	-	-	917
Secured by mortgages on immovable property	-	-	568,886	9,991	621	-	-	-	579,498
Short term claims on institutions and corporate	-	21,426	-	2,188	-	-	-	-	23,614
Past due items	-	-	-	-	-	-	210	-	210
Other items	1,847	-	-	-	-	10,660	-	425	12,932
<b>Total</b>	<b>249,945</b>	<b>21,426</b>	<b>568,886</b>	<b>63,013</b>	<b>1,538</b>	<b>611,154</b>	<b>210</b>	<b>425</b>	<b>1,516,596</b>

Exposure values for each of the standardised credit risk exposure classes associated with each credit quality step are presented in below tables.

**Table 18: Credit risk exposure by CQS**

2017 (£'000)	Risk weight	Credit ratings (S&P's)	Exposure values	RWA
<b>CQS for Central governments or central banks</b>			<b>337,882</b>	<b>-</b>
1	0%	AAA to AA-	337,882	-
<b>CQS for Corporate</b>			<b>508,043</b>	<b>497,628</b>
2	50%	A+ to A-	18,411	9,205
3	100%	BBB+ to BBB-	86,943	86,943
4	100%	BB+ to BB-	55,865	55,865
Unrated			346,822	345,614
<b>CQS for Institutions</b>			<b>2,415</b>	<b>483</b>
2	20%	A+ to A-	2,415	483
<b>CQS for Short term claims on institutions and corporate</b>			<b>23,268</b>	<b>5,755</b>
1	20%	A-1+ to A-1	19,597	3,919
2	50%	A-2	3,671	1,836
<b>CQS for Secured by mortgages on immovable property</b>			<b>674,350</b>	<b>236,310</b>
Unrated			674,350	236,310
<b>Retail</b>			<b>873</b>	<b>613</b>
<b>Past due items</b>			<b>2,478</b>	<b>3,716</b>
Unrated			2,478	3,716
<b>Other items</b>			<b>13,887</b>	<b>13,401</b>
<b>Grand Total</b>			<b>1,563,196</b>	<b>757,906</b>

2016 (£'000)	Risk weight	Credit ratings (S&P's)	Exposure values	RWA
<b>CQS for Central governments or central banks</b>			<b>248,098</b>	<b>-</b>
1	0%	AAA to AA-	248,098	-
<b>CQS for Corporate</b>				
2	50%	A+ to A-	14,753	7,377
3	100%	BBB+ to BBB-	67,488	67,488
4	100%	BB+ to BB-	3,019	3,019
Unrated			529,987	523,105
Total			<b>615,247</b>	<b>600,989</b>
<b>CQS for Institutions</b>				
3	50%	BBB+ to BBB-	24,728	12,364
Unrated			11,353	5,676
Total			<b>36,081</b>	<b>18,040</b>
<b>CQS for Short term claims on institutions and corporate</b>				
Unrated			23,614	5,379
Total			<b>23,614</b>	<b>5,379</b>
<b>CQS for Secured by mortgages on immovable property</b>				
Unrated			579,498	203,382
Total			<b>579,498</b>	<b>203,382</b>
<b>Retail</b>			<b>917</b>	<b>629</b>
<b>Past due items</b>				
Unrated			210	314
Total			<b>210</b>	<b>314</b>
<b>Other items</b>			<b>12,932</b>	<b>11,722</b>
<b>Grand Total</b>			<b>1,516,596</b>	<b>840,455</b>

Note: Exposure value is the amount after applying credit conversion factors (CCF) to off balance sheet exposures in accordance with the PRA regulatory rules.

## Credit Risk Mitigation (CRM)

CRM is a key aspect of effective risk management. The Bank uses a range of approaches to mitigate credit risk.

- Collateral: in the Bank's retail residential and commercial real estate businesses, a mortgage over the property is always taken to secure claims. Physical collateral is also taken in various forms of specialised lending, such as aircraft leasing.
- Financial guarantee: for some corporate lending, financial guarantees such as standby letter of credit are taken to cover unforeseen risks.

Table 20 demonstrates the extent of use of CRM techniques on credit exposures.

**Table 19: Credit exposure overview of CRM**

£'000	Exposures unsecured: carrying amount	Exposures secured by collateral	Exposures secured by financial guarantees	Exposures secured by credit derivatives
<b>2017</b>				
Loans	428,064	676,548	33,547	-
Debt securities	107,478	-	-	-
<b>Total</b>	<b>535,542</b>	<b>676,548</b>	<b>33,528</b>	-
Of Which Defaulted	-	459	-	-
<b>2016</b>				
Loans	581,317	569,713	32,936	-
Debt securities	40,708	-	-	-
<b>Total</b>	<b>622,025</b>	<b>569,713</b>	<b>32,936</b>	-
Of Which Defaulted	-	1,817	-	-

- The exposures of £676.5M are to mortgages, fully secured by 1st charge over residential properties and commercial real estate (£3.3M).
- The exposures of £33.5M consisted of 3 bilateral loans which were 100% guaranteed by standby letter of credit.
- The defaulted exposure of £0.5M related to 3 mortgages.
- The defaulted exposure of credit card is not considered here.

The effect of CRM on Standardised Approach capital requirements' calculations is illustrated in below table. RWA density which is the total RWA as a percentage of exposure post CCF and CRM, provides a synthetic metric on riskiness of each portfolio.

**Table 20: CRM effects on credit exposures and RWA**

Asset classes	Exposure before CCF & CRM		Exposure post CCF & CRM		RWA RWA density	
	On-balance sheet amount	Off-balance sheet amount	On-balance sheet amount	Off-balance sheet amount	RWA	RWA density
<b>2017(£'000)</b>						
Central governments or central banks	337,882	-	337,882	-	-	0%
Corporate	380,279	273,119	380,279	127,763	497,628	98%
Institutions	-	2,506	-	2,415	483	20%
Retail	873	4,756	873	-	613	70%
Secured by mortgages on immovable property	673,789	2,805	673,789	2,805	236,310	35%
Short term claims on institutions & corporate	113,901	61	113,901	61	5,755	25%
Higher-risk categories	3,040	-	3,040	-	5,121	168%
Other items	13,326	-	13,326	-	11,996	90%
<b>Total</b>	<b>1,543,090</b>	<b>283,247</b>	<b>1,432,396</b>	<b>130,800</b>	<b>757,906</b>	<b>48%</b>
<b>2016(£'000)</b>						
Central governments or central banks	248,098	-	248,098	-	-	0%
Corporate	582,753	251,414	489,540	125,707	600,989	98%
Institutions	34,989	2,371	34,989	1,092	18,040	50%
Retail	917	4,305	917	-	629	69%
Secured by mortgages on immovable property	578,877	1,242	578,877	621	203,382	35%
Short term claims on institutions & corporate	91,988	1,694	23,275	339	5,379	23%
Higher-risk categories	635	-	635	-	1,377	217%
Other items	12,507	-	12,507	-	10,660	85%
<b>Total</b>	<b>1,550,764</b>	<b>261,026</b>	<b>1,388,838</b>	<b>127,759</b>	<b>840,456</b>	<b>55%</b>

Higher-risk categories refer to assets with risk weight at 150% or higher reflecting higher risks associated with RWA density of 168% (2016: 217%). As required by the Basel Framework, the Bank discloses the higher-risk categories that are not in other regulatory portfolios. As indicated on the above table, all the exposures on past due items (£2.48M) are included in higher-risk category (£3M).

## 6. Counterparty Credit Risk (CCR)

Counterparty credit risk refers to the risk that a counterparty to a transaction may default prior to the satisfactory final settlement of the cash flows of one of the following types of the transactions: derivative instruments, securities or commodities lending, long settlement transactions and margin lending transactions.

BOC UK uses Murex system for CCR measurement purpose.

The derivative portfolio consisted of interest rate swap, FX swap and FX spot. All the transactions of the derivative contracts occurred between internal BOC Group entities. The Bank applies Standardised Approach and Standardised CVA to calculate its total CCR capital charge.

### **Composition of Collateral for CCR Exposure:**

The Bank has not received nor provided collateral in respect of derivative contracts. As a result, the impact of a downgrade of the Bank's credit rating and the resulting increase in margin requirements is not expected.

### **Credit derivatives exposures:**

The Bank does not hold any credit default swaps (CDS) or total return swaps (TRS) in either banking book or trading book. Disclosures for credit derivative transactions are not applicable.

Exposures to central counterparties: the derivative transactions in the Bank's portfolio do not involve any qualifying or non-qualifying central counterparties. Therefore, there is no exposure to central counterparties and no capital allocation is needed.

## CCR Exposure by Standardised Approach (SA-CCR)

The Bank previously applied Current Exposure Method to calculate the default risk capital charge for CCR. Basel III in a paper issued in January 2015 requires banks to provide a comprehensive view of the methods used to calculate CCR regulatory requirements and the main parameters used within each method. The Standardised Approach (“SA”) for measuring CCR exposure at default (EAD) was introduced by Basel III in March 2015 to replace Current Exposure Method and Standardised Method. The Standardised Approach was in force from 1 January 2017.

The limitations of Current Exposure Method are that it does not differentiate between margined and unmargined transactions, and the recognition of netting benefits is too simplistic. The weaknesses of Standardised Method are that the relationship misrepresentation between current exposure and potential future exposure, and inadequacy to provide a true non-internal model alternative for calculating EAD.

In order to address the deficiencies of the Current Exposure Method and Standardised Method, the Basel Committee’s formulated the SA-CCR with main objectives to devise an approach that is suitable to be applied to a wide variety of derivatives transactions (both margined and unmargined, as well as bilateral and cleared). The SA-CCR applies to OTC derivatives, exchange-traded derivatives and long settlement transactions. The Bank holds unmargined OTC derivatives only.

SA-CCR takes two components the replacement cost (RC) and the potential future exposure (PFE) to calculate the EAD<sup>7</sup>. The total SA-CCR EAD is derived from the sum of RC and PFE.

The RC is obtained by marking the contracts to market. The PFE is reflected by add-on factors, which is an estimate of the total notional principle amount split by residual maturity. The PFE consist of a multiplier that allows for the partial recognition of excess collateral and an aggregate add-on, which is derived from add-ons developed for each asset class. The mechanics for calculating add-ons hinges on the key concept of a “hedging set”, which is a set of transactions within a single netting set within which partial or full offsetting is recognised.

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<sup>7</sup> Mathematically: SA-CCR EAD=  $\alpha$  \* (RC+PFE),  $\alpha=1.4$ , which is set by the Basel Committee.

**Table 21: Analysis of CCR exposure under Standardised Approach by contract type**

£'000	2017
Interest rate swap	-
FX Swap	-
FX Spot	-
<b>Total</b>	-

**Table 22: Analysis of CCR exposure by approach**

£'000	Replacement cost	Potential future exposure	EEPE	α for regulatory EAD	EAD post-CRM	RWA
<b>2017</b>						
SA-CCR (for derivatives)	-	-		1.4	-	-
IMM (for derivatives & SFTs)			-	-	-	-
Simple Approach for CRM (for SFTs)					-	-
Comprehensive Approach for CRM (for SFTs)					-	-
VaR for SFTs					-	-
<b>Total</b>						-

**Table 23: CCR exposure under Standardised Approach by counterparty and risk weight**

Regulatory portfolio £'000	Risk weight									Total credit exposure
	0%	10%	20%	50%	75%	100%	150%	Others		
<b>2017</b>										
Institutions	-	-	-	-	-	-	-	-	-	-
<b>Total</b>	-	-	-	-	-	-	-	-	-	-

Under CRR, the Bank applies a 0% risk weight to intragroup transactions. Intragroup transactions have been taken into account when calculating the total risk exposure for Credit Valuation Adjustment (CVA). See table 24.

## Credit Valuation Adjustment (CVA)

The CVA capital requirement was introduced by Basel III in December 2010 and then also adopted by CRD IV. In addition to the default capital requirements for CCR based on Standardised or IRB Approaches, Basel III requires banks to add a capital charge to cover the unexpected risk of mark-to-market losses on the expected counterparty risk to OTC derivatives. In this context, CVA of an OTC derivative portfolio with a given counterparty is the market value of the credit risk due to any failure to perform on agreements with that counterparty.

There are two methodologies for calculating the CVA capital charge, the Advanced Approach and Standardised Approach. The Standardised Approach was adopted by the Bank in 2015, which incorporates the key drivers of the CVA risk weight, effective maturity and discounted EAD. The CVA risk weight is based on the external credit rating of the counterparty. The effective maturity is the notional weighted average maturity. Discounted EAD is the total EAD after applying discounting factor<sup>8</sup>.

The Bank's CVA for derivative portfolio is not hedged. The CVA breakdown is displayed in the table below.

**Table 24: CVA breakdown by Advanced and Standardised Approach**

£'000	2017		2016	
	EAD post-CRM	RWA	EAD post-CRM	RWA
Portfolio subject to Advanced CVA	-	-	-	-
i) VaR component	-	-	-	-
ii) Stressed VaR component	-	-	-	-
Portfolio subject to Standardised CVA	2,359	2,526	4,076	2,366
<b>Total subject to CVA capital charge</b>	<b>2,359</b>	<b>2,526</b>	<b>4,076</b>	<b>2,366</b>

## Total CCR Capital Requirement

According to Basel III, the Bank's total CCR capital charge is determined as the sum of Standardised Approach capital charge and the standardised CVA risk capital charge.

**Table 25: Total CCR Capital Requirement**

£'000	2017	
	RWA	Capital
Standardised Approach (SA)	-	-
CVA	2,526	202
<b>Total</b>	<b>2,526</b>	<b>202</b>

<sup>8</sup> Discounting factor is defined as  $[1 - \exp(-0.05 * M)] / (0.05 * M)$ , M is the effective maturity.

## 7. Market Risk

Market risk is defined as the risk that movements in market risk factors, including interest rates, foreign exchange rates, commodity prices, credit spreads and equity prices, will reduce the bank's income or the value of its asset portfolio.

The Bank does not undertake any proprietary trading activities. All trading activities are client driven and need to be promptly squared. Main source of market risk trading book relates to foreign exchange risk, little residual position in the trading book and the accrual of interest income in foreign currency.

The Bank has identified Key Risk Indicators (KRIs) for the purpose of monitoring, reporting and managing the market risk in the book.

**Table 26: Market risk capital requirement under Standardised Approach**

£'000	2017		2016	
	RWA	Capital Requirement	December	Capital Requirement
<b>Outright products</b>				
Interest rate risk (general & specific)	-	-	-	-
Equity risk (general & specific)	-	-	-	-
Foreign exchange risk	9,694	776	11,206	896
Commodity risk	-	-	-	-
<b>Options</b>				
Simplified approach	-	-	-	-
Delta-plus method	-	-	-	-
Scenario approach	-	-	-	-
<b>Securitisation</b>	-	-	-	-
<b>Total</b>	<b>9,694</b>	<b>776</b>	<b>11,206</b>	<b>896</b>

### Foreign Exchange (FX) Risk

Foreign exchange risk is the risk that movements in various currencies could materially impact on the financial statements. FX is monitored via dedicated FX gross position limits and covers both banking and trading book, excluding the accounting base currency GBP. FX risk arises from the foreign currency Profit/Loss across all business lines and FX financial instruments. In order to manage this risk, the Bank squares the foreign currency Profit/Loss on a regular basis and uses FX financial instruments.

**Table 27: Foreign exchange position**

£'000	US Dollar	Euro	CNY	AUD	Other
31 December 2017	885	290	(415)	682	41
31 December 2016	157	(16)	(481)	492	17

## Interest Rate Risk in Banking Book (IRRBB)

The objective for IRRBB risk management is to minimise the sensitivity of the bank's earnings and economic value to market rate fluctuations.

IRRBB mainly stems from the re-pricing mismatch of assets and liabilities. The sources of interest rate risk include re-pricing risk, yield curve risk, basis risk and embedded option risk. Interest rate risk is managed based on the repricing of the underlying investments. There are no assumptions made on loan prepayments.

The Bank mainly utilizes the interest rate sensitivity gap to analyse the re-pricing risk on a static basis from both in the near term earnings perspective and the long term earnings perspective. Interest-generating assets, interest-bearing liabilities and the positions of off-balance sheet business are classified into different time buckets; interest rate-sensitive liabilities in each time bucket are subtracted from the corresponding interest rate-sensitive assets to produce a re-pricing gap for that time bucket.

The Bank adopts a key risk indicator for the purpose of monitoring, reporting and managing the IRRBB: the NII Movement Ratio<sup>9</sup>. The limit is presented as a percentage ratio in terms of net income volatility for an increase in interest rate.

The Bank also monitors the One-year Cumulative Re-pricing Gap Ratio without defining a specific limit for all currencies, expressed in sterling.

The table below shows the sensitivity to a 100bps change in interest rates, with all other variables held constant, of the Bank's income statement.

**Table 28: Impact of 100 bps parallel shift on interest risk**

£'000	100 bps parallel increase	100 bps parallel decrease
Sensitivity of projected net interest income at <b>31 December 2017</b>	<b>1,913</b>	<b>(1913)</b>
31 December 2016	(1,245)	1,245
Sensitivity of reported equity to interest rate movements at <b>31 December 2017</b>	-	-
31 December 2016	100	(100)

Interest rate movements affect reported equity in the following ways: 1) retained earnings; arising from increases or decreases in net interest income and the fair value changes reported in profit or loss and 2) fair value reserves; arising from increases or decreases in fair values of available for sale financial instruments reported directly in equity.

<sup>9</sup> An instrument that measures the maximum level of adverse variation of net interest income affected by a specified interest rate change on the book.

## 8. Operational Risk

Operational risk is defined as any instance where there is a potential or actual impact to the Bank resulting from inadequate or failed internal process, people, systems, or from an external event. The impact to the Bank can be financial, including losses or an unexpected financial gain, as well as non-financial such as customer detriment, reputational or regulatory consequences.

Operational risks are inherent in the Bank's business activities. It's not cost effective to eliminate all operational risk and in any event it would not be possible to do so. Small losses from operational risks are expected to occur and are accepted as part of the normal course of business activities. The Bank seeks to reduce the likelihood of operational risk in line with the risk appetite.

The Operational Risk comprises the following key risks: fraud, transaction operations, people, premises, system and legal. In practice, the Bank's operational risk management extends beyond the key risks.

The Bank has a comprehensive Operational Risk Framework in line with the CRD IV, Basel guidelines 'Sound Practices for Management and Supervision of Operational Risk 2011'.

The Bank continues to use Basic Indicator Approach to calculate the operational risk capital requirement, which is 15% of the average annual gross income over the previous three years. The losses, stress testing scenarios and effective controls are taken into consideration when calculating capital. The Bank accumulates loss data to build the foundation for more advanced approach.

**Table 29: Operational risk capital requirement using BIA**

<b>£'000</b>	<b>RWA</b>	<b>Capital Allocation</b>
31 December 2017	161,079	12,886
31 December 2016	148,088	11,847

## Operational Risk Management

The Bank is committed to the measurement and management of operational risk. The ORC was set up to monitor and manage operational risk activities. The committee meet quarterly and reports to the BRC. The Bank uses the following tools to identify, assess, monitor, report and control operational risk:

- **Control self-assessment:** the Bank assesses all processes underlying in its department/business lines against a library of potential threats and vulnerabilities and considers the potential impact. The Control self-assessment process evaluates inherent risk, the effectiveness of the control environment and residual risk.

The Bank conducts Control self-assessment annually across all departments and remedial actions are derived with cooperation of relevant departments in order to mitigate risk occurrence in future.

- **KRIs:** are risk metrics and/or statistics that provide regular insights into a Bank's risk exposure. The aim is to ensure that all the major risk exposures are captured by KRIs in each department. The Bank has a well established list of KRIs for different departments which are reviewed annually and approved by the ORC and BRC. KRIs are collected monthly and reported quarterly on a R-A-G flag basis.
- **Operational Risk Loss Event/ Data:** Operational Risk Loss Data provides meaningful information for assessing the Bank's exposure to operational risk and effectiveness of internal controls. All events are classified in one of the 7 Basel II loss event categories.

The Operational Risk Loss Event data is collected on a monthly basis from all departments irrespective of the amount. The Bank records all losses actual, potential or near miss. Operational Risk team then conduct critical events analysis and recommend actions plan in agreement with the correspondent department. The summary of Operational Risk Loss Event is reported quarterly to the Senior Management, ORC and BRC.

- **Control Affirmation Process:** where the departments reassess existing controls and affirm the effectiveness in mitigating the risk and review if controls are still applicable. The Bank conducts Control Affirmation Process annually. The findings of Control Affirmation Process are presented annually to the ORC and BRC for recommendations and approvals.
- **Stress Testing and Scenario Analysis:** a process of obtaining expert opinion of business line/departments to identify potential operational risk events and assess the potential outcome. The Bank has developed various operational risk scenarios that provide potential sources of significant operational risk and the need for additional risk management controls or mitigation solutions.
- The Bank uses Group Operational Risk Monitoring & Analysis Platform (ORMIS) for risk reporting purposes.

## 9. Remuneration

In alignment with the Capital Requirements Regulation (CRR) remuneration disclosure requirements, the FCA's General Guidance on Proportionality: The Remuneration Code (the Code) (SYSC 19) and the PRA's LSS8/13, "Remuneration Standards: the Application of Proportionality", the Bank has been classified as a proportionality Level Two firm.

The following constitutes the Bank's remuneration disclosure under Pillar 3 and sets out the details required under the Code and Pillar 3 Disclosures on Remuneration as they apply to the Bank for the year ended 31 December 2017.

### Remuneration Policy - Governance

The Remuneration Committee ('RemCo') of the Bank is responsible for the implementation of effective remuneration governance and related risk management practices. The RemCo met quarterly throughout 2017 and its primary purpose is to:

- Review and recommend local Executive Directors' remuneration aligned to external/internal salary bandings to the Board for review and Head office for approval.
- Review expatriate Executive Directors' remuneration aligned to appropriate external/internal salary bandings.
- Recommend and monitor remuneration structures for second tier management and defined material risk takers/code staff (as defined under the Code and the European Banking Authority's (EBA) Remuneration Guidelines).
- Set the principles and parameters of the Remuneration Policy.
- Undertake annual independent review of the Remuneration Policy and framework.
- Review and approve people related policies regarding recruitment, learning and development, assessment and performance appraisal.

The Terms of Reference of the RemCo were last reviewed and updated in March 2017.

### Composition of the Remuneration Committee

The RemCo comprises four members, being:

- Dr Gerard Lyons – Independent Non Executive Director, Chairman of the Remuneration Committee;
- Mr Charles Hardy – Independent Non Executive Director;
- Mr Yu Sun – Chief Executive Officer and Director; and
- Ms Tracey Rutherford – Head of Human Resources.

## Role of Relevant Stakeholders

The RemCo is supported by the Bank's Board Risk Committee on risk related matters including the specific measures and wider issues relating to risk and business protection and also by the Legal and Compliance department on risk and performance related issues.

In no case is any person present when their own remuneration is discussed.

In performing its duties, the RemCo has sought external advice from PwC in relation to the application of the FCA Remuneration Code, from Ernst & Young regarding application of EBA Regulatory Technical Standards (RTS) and Material Risk Takers and from McLagans in relation to remuneration benchmarking including market practice and peer group methodology.

## Remuneration Policy

The RemCo is guided by the overarching principles of the Bank's Remuneration Policy; the objective of the policy is to clearly document the practices of the Bank in regards to the remuneration of its employees.

The Bank's Remuneration Policy recognises and supports the fact that appropriate levels of remuneration and compensation are necessary to attract, retain and motivate high quality people required to lead, manage and serve the Bank in a competitive financial services environment whilst complying with all relevant regulatory requirements.

The Bank has a robust framework in place to ensure that the level and composition of remuneration:

- Is reasonable and both clearly and measurably linked to performance;
- Is appropriate for results achieved;
- Encourages behaviour consistent with the Bank's core competency model and core values which leads to excellence and the appropriate balance in financial performance, governance, controls, risk management, customer service, people management, brand and reputation management.

## Remuneration Framework

The composition of remuneration and benefits comprise:

- Basic salary which is determined by having regard to external market remuneration benchmarking data and other relevant information;
- Benefits which are also determined by having regard to external market benchmarking data and the requirements of the Bank's employees as part of a flexible benefit scheme;
- Discretionary Bonus which is performance based variable remuneration determined by the outcome and achievement of performance measures and competences applied to employees within a balance scorecard framework.

Discretionary awards as referred above qualify as “variable remuneration” as defined in the Code.

The RemCo discuss and review Risk and Compliance/Senior Management employee's remuneration on an annual basis to ensure they are remunerated independently of the businesses they oversee. This process is completed in the 1st quarter annually to align to annual remuneration reviews.

Independent Non Executive Code Staff do not participate in variable pay arrangements.

## Link between Pay and Performance

The Bank's remuneration policies are designed to allow the Bank to attract and retain talented individuals needed to deliver the business strategy. The Bank manages the risk implications of its remuneration arrangements in a number of ways, including:

- Striking the optimal balance between ‘fixed’ elements of pay (base salary, benefits and pension), and ‘variable’ pay (annual discretionary bonus) to ensure variable pay overall and on an individual-by-individual basis remains an appropriate proportion of total pay;
- Ensuring performance for all variable pay plans is measured by reference to a range of factors including non-financial objectives, which take into account risk, sustainability of performance and the Bank's core competences and values in order to take a rounded view of performance;
- Retaining the requirement to effect clawback and malus provisions of the Remuneration Policy in relation to any deferred bonus elements. Clawback and malus will be initiated and enforced in line with the Bank's Risk Management risk adjustment and performance adjustment assessment and the Bank's disciplinary procedure; and

- Ensuring that any discretionary bonus scheme will not be applied unless the Bank achieves performance objectives as determined at the beginning of each financial year.

## Risk and Performance Adjustments

The Risk and Performance Adjustment considerations that are applied by the Bank are:

- Consideration of the ongoing performance of the Bank that could be impacted by an individual, including profitability, specific losses incurred or written off and any new provisions made during any variable award period;
- That during any variable award period investigations by external auditors and regulators are without material qualification or disclose undue risk (taken by an individual);
- That future risks to be considered for Credit and Market Risk include through the non performing loans (NPLs) ratio and VaR; and
- That any misstatement or misconduct or breach of policy or procedure by any individual be considered accordingly with Compliance, Operational Risk, Internal Audit or any other internal reports to be considered as appropriate.

## Application of Code Staff/Material Risk Takers

Under the definition provided by the EBA's RTS EU Regulation No 604/2014, the Bank currently considers the following categories of staff to be material risk takers (previously referred to as Code Staff):

- Staff who perform significant influence functions for the Bank (as defined within the FCA Handbook);
- Staff with responsibility for management and supervision, and who report directly to the governing body, a member of the governing body, the CEO, or a Deputy/Assistant General Manager responsible for significant business lines;
- Staff whose total remuneration takes them into the same bracket as Senior Management; and
- Staff whose professional activities could have a material impact on the firm's risk profile including market, credit and interest rate risk, and funding, liquidity, reputational and operational risk, with particular focus on risk in relation to the Bank's capital.

It is recognised that in applying the EBA's extended scope of Capital Requirements Directive IV in relation to remuneration that RTS have been established and define specific criteria to further identify categories of employees whose activities have a material impact on institutional risk (material risk takers); the Bank reviewed their application of Material Risk Takers when RTS came into force.

## Annual Discretionary Bonus Award for Code Staff/Material Risk Takers

Code Staff/Material Risk Takers participate in the annual discretionary bonus scheme that aims to recognise and reward an employee's personal contribution to the success of the Bank. As referred to above, contribution and success is typically based on the measure of a mix of corporate and personal pre agreed objectives for the year which results in a performance rating for the individual.

For the majority of Code Staff/Material Risk Takers, discretionary bonus awards will be paid from a discretionary bonus pool which is determined following the end of the financial year based on corporate performance. This is paid as a cash award in March following the end of the financial year. The level of funding for the pool based scheme is related to the financial performance of the Bank.

Individual discretionary bonus awards will be reduced where the Bank becomes aware of any action by an individual who has exposed the Bank to any form of unplanned risk (including, but not limited to, regulatory, legal or reputational risk).

The Bank's Remuneration Policy enables deferral of discretionary bonus awards in alignment with the regulatory requirements.

The Bank's Remuneration Policy does not allow for vesting of variable remuneration deferral elements.

The deferral of variable remuneration applies to defined code staff/material risk takers only who fall outside of the current "de minimis" rules.

The Bank did not pay any guaranteed bonuses or sign on awards during the 2017 financial year.

## Remuneration Awarded

The EBA requirements on remuneration state that variable pay shall not exceed 100% of fixed pay of total remuneration (can be increased to 200% subject to shareholder approval).

**Table 30: 2017 variable remuneration awarded**

	<b>31 Dec 2017</b>
Number of staff receiving variable remuneration award	437
Total fixed pay (£)	21,595,878
Total variable pay (including discretionary bonus award, allowances and overtime) (£)	8,382,007
Total deferred remuneration paid out – previous years (£)	584,261
Total non deferred variable remuneration paid out (£)	6,562,345
Total outstanding deferred remuneration (to be paid 2018- 2024) (£)	881,858
Total severance payments made	14,035
<b>Total Remuneration (£)</b>	<b>38,020,384</b>
<b>Variable pay/fixed pay ratio</b>	<b>39%</b>

**Table 31: Analysis of remuneration amount between fixed and variable pay for code staff**

<b>31 Dec 2017 (£)</b>	Management Body	Senior Managers	Others	<b>Total</b>
Number of Code Staff	10	19	40	<b>69</b>
Fixed Pay	2,105,198	2,401,837	2,864,878	<b>7,371,913</b>
Variable Pay	803,403	862,489	1,171,055	<b>2,836,947</b>

All remuneration payments were made by cash. The Bank does not have non-cash vehicles.

The Bank paid severance payments to the value of £14,035 in 2017. There are no staff at the Bank who were paid over £888K (equivalent to €1M<sup>10</sup>). The highest paid Director was paid £396K (equivalent to €446K) in 2017.

<sup>10</sup> Converted to Euros using the exchange rate at 31 Dec 2017 1£= €1.1256



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